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No. 469

In the Supreme Court of the United States

October Term, 1964

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The opinion of the district court (R. 15–22) is reported at 216 F. Supp. 457. The opinion of the court of appeals (R. 95–116) is reported at 333 F. 2d 389.

JURISDICTION

The judgment of the court of appeals was entered on May 25, 1964 (R. 116). By order of Mr. Justice White, dated August 22, 1964, the time for filing a petition for a writ of certiorari was extended to and including September 11, 1964 (R. 117). The petition was filed on that date and was granted on December 7, 1964 (R. 118). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

A life insurance company derives its total investment income partly from non-taxable State and municipal bonds and partly from other, taxable sources. It is required annually to add to a reserve for policyholders a specific sum constituting the greater portion of its total investment income. In taxing the net taxable income of life insurance companies Congress prescribed a statutory formula which has the effect (1) of apportioning the annual addition to the reserve to non-taxable and taxable income *pro rata* and (2) of limiting the deduction allowed against taxable income to its proportionate part of the addition to the reserve. However, having in mind the constitutional intergovernmental tax immunities, Congress also provided that the tax should be adjusted if the formula resulted in the imposition of a tax "on" income from State and municipal bonds.

The question presented is whether the formula results in a tax "on" State and municipal bonds.

STATUTE INVOLVED

The relevant portions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are set forth in Appendix C, *infra*, pp. 87–95.

STATEMENT

Under the Life Insurance Company Income Tax Act of 1959 (§§ 801–820 of the Internal Revenue Code of 1954, as amended), the taxable income of a life insurance company includes the full amount of its "gain from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (§ 802(b)). "Taxable in-

vestment income" and "gain from operations" are defined in detail in §§ 804(a) and 809(b), respectively, but each of those provisions contains an "exception" providing that, if the application of the definition "results in the imposition of tax on" State and municipal bond interest, "adjustment shall be made to the extent necessary to prevent such imposition" (§§ 804(a)(6), 809(b)(4)).

In its income tax return for 1958, respondent computed its income in accordance with the statutory definitions of "taxable investment income" and "gain from operations." In due course, however, it brought this suit for refund contending that the application of the statutory definitions resulted in the imposition of tax on its municipal bond interest. The court of appeals, reversing the district court, held that the statute does impose a tax on municipal bond interest and, to eliminate that effect, adjusted respondent's tax under the "exception" clauses.

A fuller statement of the issue and of the reasoning of the court below requires an explanation of the nature of life insurance reserves and of the statutory plan for the taxation of life insurance companies. Since the statutory definitions of "taxable investment income" and of "gain from operations" present the same issue but require somewhat different computations, we will for simplicity hereafter confine the discussion, except as otherwise expressly noted, to the definition of "gain from operations," the definition that requires the simpler and more easily understood computations.[1]

[1] The selection of "gain from operations" for the major exposition can also be justified on the ground that, if anything, it is the measure that has the greater impact on the company's

1. *Life insurance reserves.*—The premiums charged for life insurance are calculated on the assumption that the premiums received by the company will be invested and earn interest which, when added to the accumulated premiums, will be sufficient to pay the policyholders' claims as they accrue. The rate of interest assumed in determining premiums is also employed in computing the "reserve" for policyholder claims which State law normally requires the company to maintain. The reserve is computed as that amount which, with an annual growth at the assumed rate of interest, will be sufficient (with the future premiums) to pay the actuarially-predicted policyholder claims. The mortality tables and the assumed rate of interest used in the computations are regulated by State law, and if the net assets of the company fall below the reserve so computed, the company is deemed insolvent and may no longer continue in business.

Since the reserve is computed by "discounting" the predicted policyholder claims to the present at the assumed rate of interest, it is obviously necessary, if the reserve is to continue to measure the company's ability to meet its policyholder obligations, that the reserve be increased each year by an amount equal to the interest that it was assumed the assets

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final taxable income. Changes in "gain from operations" will always affect taxable income by at least 50% of the amount of the change, and sometimes (when it is less than "taxable investment income") by 100%. Changes in "taxable investment income," on the other hand, never affect taxable income by more than 50% of their amount, and sometimes (when it exceeds "gain from operations") not at all. See § 802(b).

represented by the reserve would earn. Thus, out of the income actually earned each year from the investment of the premium receipts, a certain portion—that part representing the assumed rate of interest—must be "set aside" and added to the reserve to "fund" the anticipated policyholder obligations.

2. *The statute.*—The basic problem which the Act of 1959 sought to resolve is—how to define and treat the additions to the reserve for tax purposes. The basic principle adopted by Congress is clear. Congress continued to follow, albeit in a new form, the longstanding policy of not taxing the portion of a life insurance company's income that is required to be set aside as an addition to the reserve. In computing "gain from operations" under the statutory definition, the total "investment yield" (investment income less investment expenses) is divided between the "policyholders' share" and the "company's share." The amount allocated to the policyholders is equal to the assumed interest rate times the reserves (the "required interest," § 809(a)(2)) and thus represents the amount required to be added to the reserves to fund the predicted policyholder claims. The amount allocated to the company is simply the balance. The "policyholders' share" so determined is wholly excluded from the company's income and only the "company's share" enters into its "gain from operations." In short, the company is taxed only on the excess of the investment income over the amount required to be added to the reserves.

So much is clear. The difficulty arises from the fact that since total investment income is, of course,

composed of many different kinds of income (dividends, royalties, rents, taxable interest, tax-exempt interest, *etc.*), it is further necessary to say of what kinds of income the "policyholders' share" and the "company's share" are to be deemed composed. The statute solves that problem by allocating each item of income pro rata between the two shares. Thus, if the required addition to the reserve is $800,000 and the investment yield for the year is $1,000,000, 80% of each item of income is allocated to the policyholders and excluded from the company's income. The $200,000 allocated to the company is deemed to be composed of the remaining 20% of each item of income and is taxed accordingly, with the appropriate deductions then being allowed for tax-exempt interest, intercorporate dividends, *etc.* If, for example, the $1,000,000 investment yield included $100,000 of tax-exempt interest, the company's $200,000 share of the total investment yield would be deemed to include $20,000 (*i.e.*, 20%) of the tax-exempt interest and the amount subject to federal income tax would accordingly be reduced by that amount, leaving $180,000 to be included in "gain from operations." The other $80,000 of tax-exempt interest is deemed to have been already excluded as a part of the policyholders' $800,000 share of the total income, so that no further exclusion on its account is required.[2]

[2] The method of computing "taxable investment income" is substantially identical except that, in determining the amount of income to be allocated to the policyholders (called the "policy and other contract liability requirements"), the reserves are multiplied, not by the assumed rate of interest (as in computing "gain from operations"), but by the rate of return

The necessary effect of the statutory formula is that the receipt of tax-exempt interest will cause the company's "gain from operations", and hence its tax liability, to be higher than it would have been if that interest had not been received. That may be seen by comparing the example just given ($1,000,000 investment yield including $100,000 of tax-exempt interest, which produces $180,000 of taxable gain from operations) with the result that would be reached if the tax-exempt interest were eliminated, leaving $900,000 of investment yield composed entirely of taxable items. Because the "required interest" is a fixed amount (reserves times assumed interest rate) determined without reference to actual investment yield, the amount allocated to the policyholders would still be the same $800,000 and only $100,000 would be left as the company's share to be included in "gain from operations." Thus the receipt of an additional $100,000 of income in the form of tax-exempt interest causes "gain from operations" to be increased by $80,000.[3]

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actually realized by the company from the investment of its assets (either during the current year or, if lower, during the past five years) (§ 805). The effect of using the earnings rate rather than the assumed rate is dampened, however, by a further adjustment which reduces the amount so determined by 1% for every tenth of a percentage point by which the earnings rate exceeds the assumed rate; if the earnings rate is less than the assumed rate, the amount is increased by the same ratio (§ 805(c)(1)(B)). The net effect is the same as though the reserves were multiplied by a rate somewhere in between the assumed rate and the earnings rate.

[3] The computation of gain from operations on the assumed facts is illustrated both in tabular form and graphically in Appendix A, *infra*, pp. 79–83.

The explanation of that result is simple. Because the absolute amount of income allocated to the policyholders is a constant (equal to the "required interest"), the *fraction* of the investment yield that must be allocated to them decreases as the investment yield increases. To give the policyholders $800,000 requires 100% of an investment yield of $800,000; 88.9% of a yield of $900,000; and only 80% of a yield of $1,000,000. By increasing the investment yield, therefore, the receipt of tax-exempt interest reduces the fraction of all the other income that must be allocated to the policyholders, thus leaving a larger part of the other income to be included in the company's gain from operations. In short, the reason that the receipt of tax-exempt interest causes an increase in tax is simply that it provides a larger base out of which the fixed claims of the policyholders can be satisfied, thus reducing their claims against the taxable items of income.[4]

Having defined "gain from operations" in a way necessarily causing it to be increased upon the receipt of municipal bond interest—the inevitable result of the pro rata allocation of such interest between the

[4] The described consequences are those of the receipt of *additional* income in the form of tax-exempt interest. Very different is the case of a *substitution of* tax-exempt income for taxable income, which results instead in a decrease in tax fully commensurate with the extent to which the company's taxable income is taxed. With a fully taxable investment yield of $1,000,000 and a policyholder's share of $800,000, only 20% of the investment yield would be included in gain from operations. Commensurately, gain from operations would be reduced by 20% of any part of the investment yield that was shifted from taxable income to tax-exempt income.

"policyholders' share" and the "company's share"—the statute concludes with the "exception" clause on which the decision below was based. That clause (§ 809(b)(4)) provides that:

> If it is established in any case that the application of the definition of gain from operations * * * results in the imposition of tax on [municipal bond interest, *inter alia*] * * *, adjustment shall be made to the extent necessary to prevent such imposition.

3. *Facts and proceedings below.*—During 1958, respondent received interest on municipal bonds in the amount of $36,637. Its total "investment yield," including that interest, was $894,277. The "required interest" on its reserves was $781,540 (R. 100).

In its income tax return for 1958, respondent computed its "gain from operations" in accordance with the statutory definition. A part of the investment yield ($894,277) equal to the required interest on the reserves ($781,540) was excluded as the "policyholders' share," leaving $112,737 as the "company's share." The company's share, being 12.6% of the total investment yield, was treated as including 12.6% of the municipal bond interest, or $4,619. A deduction was taken for that amount, leaving $108,118 as the net investment income to be included in gain from operations.

In its claim for refund and in the proceedings below, respondent claimed that the application of the statutory definition "result[ed] in the imposition of tax on" its municipal bond interest because it resulted in a higher gain from operations (and hence tax) than

there would have been if it had not received the tax-exempt interest. To prevent that result, it contended, its gain from operations should be recomputed under the "exception" clause by eliminating the municipal bond interest from the "investment yield" at the outset, reducing the investment yield to $857,640. The same amount would then be excluded as the "policyholders' share" ($781,540), leaving only $76,100 as the net investment income to be included in gain from operations. The resulting $32,018 reduction in gain from operations is exactly equal, it may be seen, to the portion of the municipal bond interest (87.4%) which the statutory formula allocated to the policyholders. The essential difference in the computations is that the statutory formula treats the amount allocated to the policyholders as consisting of a pro rata part of every item of income, including municipal bond interest, while respondent's computation allocates to the policyholders only taxable items of income and allocates all of the municipal bond interest to the company.[5]

The district court held that respondent was not being taxed on its municipal bond interest under the statutory definitions and denied the refund. The court of appeals reversed. It construed this Court's decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313, as meaning that a tax is unconstitutionally imposed "on" tax-exempt interest

[5] Respondent's method of computation is illustrated in tabular form and compared with the method prescribed by the Act in Appendix A, Schedule A, pp. 80–83, *infra*.

whenever "the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest" (R. 114). By that standard, a tax was being imposed "on" respondent's municipal bond interest, since its tax was greater than it would have been if that interest had not been received. Since the court considered itself bound by the *National Life* and *Gehner* decisions as to what constitutes a tax "on" tax-exempt interest, and since any challenge to the constitutional immunity of municipal bond interest from taxation was foreclosed by the "exception" clauses of the statute, the court held that respondent was entitled to adjust its tax, under the "exception" clauses, to what it would have been if the municipal bond interest had not been received. Specifically, the court approved respondent's reduction of its "gain from operations" from $108,118 (the result under the statutory definitions) to $76,100 (the result under respondent's method of computation described above).

SUMMARY OF ARGUMENT

For over forty years Congress has allowed life insurance companies a deduction or exclusion for the annual "interest" addition to the policyholders' reserve which is necessary to pay future claims. Whether the addition to the reserve has been deducted from gross income on the ground that it is the cost of using premium receipts to earn both taxable and tax-exempt investment income for the company or has been excluded from gross income on the ground that it represents a part of the investment income which is never beneficially enjoyed by the company, Con-

gress has also recognized, for over forty years, the need of an accommodation between the reserve exemption and the exemption for interest from State bonds. The accommodation adopted in the 1959 Act is in principle identical to that used, without challenge, since 1942. The addition to the reserve is considered attributable, on a pro-rata basis, to the company's taxable and tax-exempt investment income.

1. In enacting the accommodation found in the 1959 Act, Congress fully respected the traditional constitutional immunity of interest from State bonds. There is simply no way of determining which items of *gross* income a *net* income tax is "on" without first determining what deductions are properly attributable to each item of gross income and what items of gross income are attributable to the taxpayer. Congress has made this determination fairly in the 1959 Act and then has allowed a full exemption for tax-exempt interest.

a. If the exemption is treated as a deduction for the principal cost of producing both taxable and tax-exempt investment income for the company (as the respondent contends it should be), the deduction can and should be reduced to the extent that it is properly attributable to the production of tax-exempt income. This is all that the 1959 Act has done. Congress does not generally allow deductions against taxable income if, or to the extent, an expense is not the cost of producing taxable income. One application of this general rule is the denial of a deduction for personal expenses (§ 262); another is that Congress need not permit deductions against taxable income for the costs of producing tax-exempt income. This is the precise

holding of *Denman* v. *Slayton*, 282 U.S. 514, and *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, and controls the present case.

b. If the reserve exemption is considered an exclusion of that part of the investment income which the company holds in trust for the policyholders and does not itself beneficially enjoy—and, in view of the function and State regulation of the reserve, Congress could so consider it—the excluded share should be treated, like ordinary trust income (see § 662), as made up of pro-rata portions of each class of gross income. The company should be allowed to deduct only that part of the total tax-exempt interest which has not already been excluded as beneficially the property of the policyholders. No other method of determining the taxable and tax-exempt content of the shares of total investment income going to the company and the policyholders' reserve has any claim to fairness or rationality.

c. The apportionment of a single item of expense pro rata between the types of income it helps to produce and the denial of a deduction for that part of the expense attributable to producing tax-exempt income necessarily means that the expense deduction will be reduced when the taxpayer receives additional tax-exempt income. Similarly, the allocation of a pro-rata part of tax-exempt income to satisfy the fixed and prior claims of one beneficiary (here the reserve for policyholders) necessarily means that the other beneficiary (here the company) will have more taxable income left when there is more tax-exempt income. In both cases, the result is an increase in net taxable in-

come when there is an increase in tax-exempt income. But this fact alone has never been held to establish that a tax is imposed on tax-exempt income. See, *e.g.*, *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371; *Butler Bros.* v. *McColgan*, 315 U.S. 501; *cf. Pacific Co.* v. *Johnson*, 285 U.S. 480; *Greiner* v. *Lewellyn*, 258 U.S. 384.

2. Because the statutory formula is consistent with the traditional constitutional immunity from taxation of interest from State bonds, the "exception" clauses (§§ 804(a)(6) and 809(b)(4)) are inapplicable. By their terms, the clauses apply to require a judicial adjustment of the statutory formula only if a tax had been imposed "on" interest from State bonds. Both the interrelationship of the various sections of the 1959 Act and its legislative history demonstrate that the determination whether a tax was imposed on interest from State bonds is to be made by reference to the only context where these terms have previously been used, the traditional constitutional immunity, and not to some unspecified but allegedly more stringent Congressional standard enacted simultaneously with the statutory taxing formula.

Obviously Congress did not first enact a detailed taxing formula and then ask the courts to determine whether it was consistent with some other Congressional policy enacted in general terms as an "exception" in the same Act; Congress decides for itself the consistency of two of its own policies. In particular, Congress could not have intended to require, by the "exception" clauses, a judicial modification of the statute whenever the receipt of tax-exempt interest

increased the company's tax, for that was the plain, necessary, and intended effect of the statutory formula. Nor did Congress intend the same self-contradictory result by incorporating the broadest implications of those decisions of this Court relied upon by the opponents of the Act, without regard to subsequent decisions which further rationalized and developed the scope of the immunity; the "exception" clauses refer to the whole immunity doctrine, not to particular decisions by name. In short, Congress meant the courts to measure its statute against an external standard as to which they were more expert than Congress—the traditional constitutional immunity. This conclusion is fully confirmed by the legislative history which shows that the function of the "exception" clauses was to reassure those who were anxious to maintain the established immunity of State bonds and to prevent a defense of the statute which would cast that immunity in doubt.

ARGUMENT

Introduction

Because State law requires life insurance companies to add an "interest" or "income" item each year to the reserve fund they must hold to meet policyholders' future claims, the federal income tax has, for over forty years, afforded life insurance companies the unique tax advantage of not paying tax on most of the investment income they receive, *i.e.*, on the income which must be added to the reserve fund under State law. The company's income out of which is made the required addition to the reserve

for policyholders (or, alternatively viewed, the income earned at the cost of the annual addition to the reserve fund) generally includes interest from bonds of States or their subdivisions (hereafter "State bonds"), a type of income always exempted from the federal income tax. For over forty years Congress has attempted to accommodate the deduction for additions to the policyholders' reserve to the exemption for interest from State bonds so as to reflect the fact that part of the addition to the reserve is attributable to tax-exempt income. The question in the present case concerns the accommodation enacted in the Life Insurance Company Income Tax Act of 1959.

There are three basic approaches to the problem. To illustrate, assume that a life insurance company, which has $100 of net investment income ($90 in taxable income and $10 in tax-exempt interest), is required to add $80 to its reserve for policyholders. Pattern A assumes that all the tax-exempt dollars are added to the reserve along with $70 of taxable items. The result is that after the addition to the reserve the company is left with $20 of taxable income. Pattern B assumes that no tax-exempt dollars are added to the reserve, which is given $80 in taxable items. From the remaining $20 attributed to the company, the 10 tax-exempt dollars would then be subtracted, leaving a taxable income of only $10. The third approach, Pattern C, would treat the company and the reserve for policyholders as each receiving a pro-rata share of the taxable and tax-exempt dollars. The reserve, which receives 80 per-

cent of the total income would receive 80 percent of the taxable dollars ($72) and 80 percent of the tax-exempt income ($8). The company would be taxed only on 20 percent of the taxable income, or $18.

In the Revenue Act of 1921 Congress adopted the first approach (Pattern A) and attributed all the tax-exempt income to the reserve for policyholders. 42 Stat. 227, 261. That treatment was held unconstitutional in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, as imposing a tax on interest from State bonds. After a lapse of some years during which the statute was not amended, Congress passed the Revenue Act of 1942 adopting what we have called Pattern C, a pro rata allocation of taxable and tax-exempt dollars to both the policyholders' reserve and the company. The allocation was accomplished on an industry-wide formula so that a particular company's reserve deduction was reduced by an increase in industry holdings of tax-exempt bonds, but not by an increase in its own holdings of these bonds. 56 Stat. 870. The reason for the 1942 amendments was clearly explained: "under existing law life insurance companies are in effect allowed to deduct part of their tax-exempt interest twice. * * * Part of the earnings on the reserve is derived from tax-exempt interest; yet the whole allowance for reserve earnings is deducted from taxable investment income." H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 107–108; see also S. Rep. No. 1631, 77th Cong.,

2d Sess., p. 142. The Revenue Act of 1942 eliminated most of the double allowance Neither the 1942 formula nor similar successors was ever attacked as imposing a tax on State bonds despite their use in the period 1942–1957.

In the Life Insurance Company Income Tax Act of 1959 Congress continued the pro-rata allocation of part of the tax-exempt interest to the policyholders' reserve, but specified that this allocation should be applied to each individual company rather than on an industry-wide basis. The sole question presented in this case is whether the application of Pattern C to individual insurance companies under the 1959 Act imposes a tax on interest from State bonds.

The question whether a federal tax is on income from State bonds has meaning only in the context of actual or supposed intergovernmental immunities. If the 1959 Act did not contain the exception clauses, a challenge to its constitutionality would present two questions: (1) whether the Act imposes a tax on interest from State bonds; and (2) whether, if it does, Congress has the power to tax such interest. The latter issue, it is important to note, would be a very substantial question, for the decisions of this Court sustaining the power of Congress to tax income from renting property, selling goods, or furnishing services to a State have created serious doubts about the continuing vitality of the earlier d sions denying the power of Congress to tax income from lending money

to a State.[6] That question, however, was pretermitted by the exception clauses, and we take it as a predicate that no tax may be constitutionally laid on income from State bonds. We show in Point I that the 1959 Act does not impose a tax on the income from State bonds such as would offend the assumed constitutional prohibition. In Point II we show that the exception clauses do no more than prohibit a tax on State bonds in the constitutional sense.

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[6] In the past thirty years and subsequent to this Court's last decisions holding the income from State bonds constitutionally immune from federal taxation, the Court has undertaken a major reconsideration of the scope of intergovernmental immunities. During this period it has held that a private party can be taxed by the United States on his salary from a State (*Graves* v. *New York*, 306 U.S. 466) and can be taxed by a State on his gross receipts as an independent contractor from furnishing services to the United States (*James* v. *Dravo Contracting Co.*, 302 U.S. 134), on his gross receipts from sale or rental of property to the United States (*Alabama* v. *King & Boozer*, 314 U.S. 1), and even on the value of the use of federally owned property (*United States* v. *City of Detroit*, 355 U.S. 466). The anomaly, in light of these decisions, of continuing to deny the federal government the power to tax a private party's receipts from lending money to a State has been made the subject of a major study by the Department of Justice (*Taxation of Government Bondholders and Employees*, Government Printing Office, 1939) and has been emphasized by leading authorities (see, *e.g.*, Gray, *Derivative Tax Immunity and the Income From State Bonds*, 41 Col. L. Rev. 1357). The immunity has also been attacked by Presidents of every political persuasion from Harding and Coolidge to Hoover and Roosevelt (see Department of Justice Study, *supra*, at pp. 201–202).

I

THE STATUTORY FORMULA DOES NOT VIOLATE THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

A. IN TAXING NET INCOME CONGRESS MAY LIMIT THE DEDUCTION ALLOWED AGAINST GROSS INCOME FROM TAXABLE SOURCES TO THE FAIRLY APPORTIONED SHARE OF AN ITEM CHARGEABLE AGAINST GROSS INCOME FROM BOTH TAXABLE AND NON-TAXABLE SOURCES

Under the Act—under Pattern C—the annual addition to the policyholders' reserve is treated as composed in part of any tax-exempt dollars of income from State bonds and in part of taxable dollars from other sources. Since the company must add a fixed amount to the policyholders' reserve, the result of treating the addition as composed in any part of tax-exempt items is that a company with only taxable income will have to add more of this income to the reserve and will retain less taxable income for itself than it would if it had tax-exempt income in addition, part of which would be used to make the necessary addition to the reserve. Under Pattern C, therefore, the receipt of an increment of tax-exempt income, all others things being equal, will necessarily increase the amount of taxable income the company has after additions to the reserve, and will thus increase its total tax.[7] That much is undisputed. The only question

[7] As shown in the Statement, that will always be so under the definition of "gain from operations." The same result will *normally* occur also under the definition of "taxable investment income", but whether it will *necessarily* occur depends upon what assumptions are made in computing what the taxable investment income "would have been" without the tax-exempt interest. "Taxable investment income" computed under the statu-

is whether this necessary result of a pro rata allocation of taxable and tax-exempt income between the policyholders' reserve and the company results in the imposition of a tax *on* interest from State bonds within the meaning of the assumed constitutional prohibition.

To determine whether a net income tax is a tax on a particular item of gross income (here, interest from State bonds), respondent and the court below offer a simple rule of arithmetic: if the tax is greater than it would have been if the taxpayer had not received the given item in addition to his other income, then the increase is a tax on that item. Since the definitions of

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tory definition will always be greater than it would have been if the company had not had the municipal bonds. It will usually, but not necessarily always, be greater than it would have been if the company had had the bonds but had not received the interest, which is the assumption respondent and the court of appeals employed in recomputing respondent's taxable investment income. Leaving the bonds in the company's assets but removing the interest from the investment yield causes a marked reduction in the earnings rate (investment yield divided by assets) and thus in the amount of income allocated to the policyholders (reserves times earnings rate, see note 2, *supra*). The reduced exclusion for the policyholders' share tends to offset the reduction in the investment yield, and in extreme circumstances can fully offset it. The justification for using wholly disparate factors in computing the earnings rate (dividing both taxable and exempt assets into the income from the taxable assets alone) is not apparent, however. Nor is it apparent why respondent and the court below are willing to tolerate the inclusion of tax-exempt bonds in the asset account when the effect is to increase taxable investment income. By the court of appeals' standard, that results in imposing a tax "on" the bonds themselves which, if anything, is surely more objectionable than imposing a tax merely on the interest from the bonds.

"gain from operations" and "taxable investment income" in the 1959 Act admittedly cause the tax liability of a life insurance company which receives interest from State bonds to be greater than it would have been if the company had not received the interest and all other items remained constant, they conclude that the Act imposes a tax on interest from State bonds. If we were dealing with a simple tax upon gross income received by a taxpayer exclusively for his own benefit without deductible costs, then it might be true to say that a tax liability which is increased because of the addition of an increment of State bond interest is, to some extent, a tax on the income from the bonds. But that is not this case; here we deal with net income after sundry subtractions from the received income coming into the company's possession.

The simplistic analysis is demonstrably irrelevant in dealing with a tax on the net income remaining to a taxpayer after offsetting against the total gross income coming into his possession allowances for income not fairly taxable to him, for costs, etc. True, one can still perform the arithmetical computation which shows that the exclusion of the increment of State-bond interest would result, all other items constant, in a lower tax, but the arithmetic is meaningless unless one also considers whether the State-bond interest has such a relation to other items entering into the determination of taxable net income that the receipt or non-receipt of the State bond justifies a change in the corresponding elements of the arithmetical computation. In other words, in judging the alleged impact of a tax upon net income upon one of

several items of gross income one cannot ignore the problems of apportioning any offsetting items as well as the tax, and the propriety of a particular apportionment cannot be determined merely by arithmetic.

The point is easily demonstrated by example. Suppose that a taxpayer has expenses of $80 and gross income of $100 consisting of four different items of income of $25 each (Items 1–4). If the taxpayer were required to pay a tax on his net income of $20, which item of gross income would the tax be imposed "on"? Arithmetic alone cannot answer the question. It is meaningless to say that the entire tax is imposed on Item 1 because without it there would have been no tax, for the same thing could be said with equal validity of each of the other items with the result that the entire tax would be found to be imposed on each. If arithmetic alone is to provide the answer, the only possible solution is to say that, since each item was equally indispensable in producing the result, they should be treated as contributing equally to the net income—*i.e.*, the $20 of net income should be deemed to consist of $5 of each of the four items of gross income and each would be to that extent the subject of the tax.

A more reasoned judgment could be made only by examining the offsetting expenses and determining how they should be allocated against the several items of income. Suppose, for example, that Expense A ($40) was a fixed expense that cannot be said to have contributed any more to the production of one item of income than another; that Expense B ($20) contributed equally to the production of Items 1 and 2

but not at all to the production of Items 3 and 4; and that Expenses C ($5), D ($8), and E ($7) were specifically incurred in producing, respectively, Items 2, 3, and 4. On that analysis of the character of the expenses, it would plainly be reasonable to charge Item 1 with $20 of expenses (¼ of A plus ½ of B); Item 2 with $25 (same, plus C); Item 3 with $18 (¼ of A plus D); and Item 4 with $17 (¼ of A plus E). With the expenses so allocated, the $20 of net income—the subject of the tax—could then fairly be said to consist of $5 of Item 1, none of Item 2, $7 of Item 3, and $8 of Item 4. And if, say, Item 3 happened to be constitutionally immune from tax, the constitution would require no more, we submit, than that the net income be reduced by $7, leaving $13 subject to tax.[8]

The problem of allocation is in no way unique to the treatment of interest from State bonds. If a taxpayer uses an automobile solely for business purposes, he can deduct, *inter alia*, the full amount of the depreciation for the year (§§ 162, 167). If he uses the automobile solely for personal purposes, he is entitled to no deductions (§ 262). If he uses the automobile partly for business and partly for personal purposes, to what extent can the depreciation be deducted? Since the annual depreciation recognized for tax purposes is generally unaffected by the extent of actual use, it could be said that the personal use, not having increased the depreciation, should be disregarded and the entire depreciation should be treated

[8] A similar example is set out in tabular form in Appendix B (Ex. 1), pp. 84–85, *infra*.

as a business cost. With equal logic, however, it could be said that it is the business use, which likewise did not increase the depreciation, which should be disregarded and that the entire depreciation should be treated as a personal expense. The solution reached under present law is, of course, neither: the depreciation is allocated in the proportion in which the taxpayer actually used the automobile for the two purposes, with only 60 percent of the depreciation being deductible if it is found that only 60 percent of the taxpayer's use of the automobile was for business purposes.[9] On the face of it, such an allocation is eminently reasonable and presents no constitutional problem. Yet under respondent's but-for reasoning the partial disallowance of an otherwise deductible cost because the taxpayer also used the automobile for personal purposes results in imposing a tax "on" his personal use of the automobile, a tax that would at least arguably be unconstitutional as an unapportioned "direct" tax (cf. *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371). The fallacy, of course, lies in the calculus that would convert a disallowance of the deduction to the extent that the expense is reasonably attributable to the taxpayer's personal use of the automobile into an imposition of tax "on" that personal use itself.

The principle is equally applicable to the allocation of expenses partly attributable to the cost of realizing tax-exempt interest. Suppose that *A* had a gross in-

[9] See, *e.g.*, *Lustman* v. *Commissioner*, 322 F. 2d 253 (C.A. 3); I.R.S. Form 2106, "Statement of Employee Business Expenses." See Appendix B (Ex. 2), p. 85, *infra*.

come of $25,000, made up of $20,000 in rents from real estate and $5,000 of income from State bonds, both purchased with borrowed funds upon which his interest payments are $20,000 annually. Properly determined, *A's* taxable net income is $4,000. The constitution does not require apportioning to the rental income ($20,000) more than its fair four-fifths share ($16,000) of *A's* total costs ($20,000). *Denman* v. *Slayton,* 282 U.S. 514. Yet here again respondent's simplistic formula would erroneously tell us that there was a tax on the State bond interest, for *A's* tax will be higher than if the non-taxable interest had not been received.

Substantially identical problems of allocation are presented in the allocation of income between co-beneficiaries (as distinguished from the allocation of expenses to income). Suppose that a trust instrument requires the trustee to pay *A* $80 a year out of the trust income (or, if necessary, out of principal) and to pay the balance of the income, if any, to *B* and that in the given year the trust has income of $100 consisting of $20 of each of five kinds of income: oil royalties, domestic dividends, foreign tax-paid dividends, interest from State bonds, and interest from corporate bonds. The total income is distributed $80 to *A* and $20 to *B*. For purposes of determining who is entitled to the percentage-depletion deduction, the dividends-received credit, the credit for foreign taxes, and the exclusion for tax-exempt interest, which beneficiary receives which income? The question can be answered only by recourse to a principle of allocation, and the only one with any claim to reason is that adopted by

Congress: *A*, having received 80 percent of the total income, is deemed to have received 80 percent of each item; *B*, having received 20 percent of the total, is deemed to have received 20 percent of each item; and *A* and *B* then account accordingly (§ 662(a)(1) and (b)).

The result, of course, is that *B* is required to pay a tax he would not have had to pay if the interest from State bonds had not been received, in which event *B* would have received nothing. Moreover, if *A* is in a lower tax bracket than *B* or is a tax-exempt entity, the total tax paid by both *A* and *B* will be greater than it would have been without the tax-exempt interest.[10] Yet we are confident that not even respondent, despite its arithmetical formula, will suggest that the trust provisions making that allocation are for that reason unconstitutional.

There is nothing novel in these propositions. The books are full of cases, in addition to *Denman* v. *Slayton, supra,* showing that neither this Court nor Congress has ever believed that every taxing formula which results in an increase in the total tax because of the receipt or ownership of tax-exempt income or property imposes a tax on that income or property. Franchise or privilege taxes can constitutionally be measured by total income, including that from State or federal bonds. See, *e.g., Flint* v. *Stone Tracy Co.,* 220 U.S. 107; *Pacific Co.* v. *Johnson,* 285 U.S. 480;

[10] A similar example of the effects of the statutorily prescribed method of allocating trust income is set out in tabular form in Appendix B (Ex. 3), pp. 85–86, *infra.*

Cf. Corporate Excise Tax, Revenue Act of 1916, § 407, 39 Stat. 789; Revenue Act of 1918, § 1000, 40 Stat. 1126; Revenue Act of 1921, § 1000, 42 Stat. 294 Revenue Act of 1924, § 700, 43 Stat. 325. The federal estate tax can constitutionally be applied to the full value of State bonds (*Greiner* v. *Lewellyn,* 258 U.S. 384) and the income tax can validly be applied to the profits made on resale of such bonds (*Willcuts* v. *Bunn,* 282 U.S. 216). A State may not constitutionally tax sales wholly unconnected with the State (*McLeod* v. *Dilworth Co.,* 322 U.S. 327), but the proceeds of such sales may be used to increase the taxpayer's total net income and, thus, to increase the fairly apportioned part of that income which the State can tax. *Butler Bros.* v. *McColgan,* 315 U.S. 501; *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113; *Northwestern Cement Co.* v. *Minnesota,* 358 U.S. 450. The fact that the total tax paid one State is increased by increased sales in other States does not mean that the tax is imposed *on* the constitutionally immune sales in other States. Similarly, any apportionment of a company's net income between the part that is taxable and the part that is constitutionally immune necessarily implies that all overhead expenses need not be deducted from the taxable gross income alone but the deduction can be reduced to the extent that, under a fair apportionment formula, the overhead expenses are attributable to constitutionally immune sales. *E.g., United States Glue Co.* v. *Town of Oak Creek,* 247 U.S. 321.

What the foregoing examples and decisions demonstrate is that it is impossible to draw a meaningful

conclusion about the subject matter of a tax on net income from the simple demonstration that the tax would have been less if a single, arbitrarily selected, item of gross income had been eliminated from the computation and everything else left the same. For in any given case it may be utterly inappropriate to leave everything the same. The computation may or may not involve deductions or allocation of items of gross income or cost. If it does, the addition or exclusion of an item of gross income—even of a non-taxable item—may call for a new allocation substantially affecting the net taxable income that results. If different allocations are reasonable, and if, after the allocations are made, appropriate deductions or exclusions are then allowed for that part of any constitutionally immune item that enters into the net income, the resulting tax cannot be said to be a tax *on* the immune item. Congress need not allocate items of expense or income in whatever way produces the least tax.

In short, the fallacy in the formula proffered by respondent and accepted by the court below is that it assumes that the same allocations and subtractions must be made on account of the reserve fund regardless of whether the taxpayer company has, or has not, received income from State bonds. The 1959 Act prescribes different allocations and subtractions. The question, however, is not whether the tax is more, but whether the changed apportionment is reasonable. We turn next to that question.

763-293—65——3

B. THE 1959 ACT MAKES A FAIR APPORTIONMENT OF THE ANNUAL ADDITION TO THE RESERVE FOR SHAREHOLDERS

In the Life Insurance Company Income Tax Act of 1959 Congress determined to adhere to a well-established policy and provide that in computing the net income of a life insurance company there should be an allowance for the annual addition to the policyholders' reserve. Since a life insurance company's income usually includes income from several sources, this determination, as we have seen (pp. 22–29, *supra*), raised a problem of allocation or apportionment: to which dollars of gross income do the dollars added to the reserve relate—exclusively to taxable dollars, exclusively (or so far as possible) to non-taxable dollars, or ratably to all?

There is no precise analogy for solving the problem. The policyholders' reserve of a life insurance company is unique. Congress evidently concluded that the interest of the policyholders in the reserve was such that the problem of apportionment could be likened to that of the allocation of taxable and tax-exempt income among the several beneficiaries of a trust. If $50,000 of income, made up of $25,000 dividends and $25,000 interest from State bonds, is received by *A* under a trust charging him with paying the first $40,000 of income annually to *B* and the rest to himself, *A* would be taxed as if he paid out four-fifths and retained one-fifth of each kind of income, *i.e.*, he would be taxed on $5,000 and receive $5,000 tax free. Similarly, in the 1959 Act Congress treated the additions to the reserve as if the policy-

holders like *B* were the beneficiaries of a trust and provided for allocating a ratable share of each item of income to the policyholders and to the company.

Respondent denies the appositeness of the analogy and asserts that the statutory treatment is a verbal form lacking reality. In its view the annual increase in its liabilities to policyholders (*i.e.*, the annual additions to the reserve) is nothing more than an accruing "cost" of doing business and the so-called "exclusion" of the "policyholders' share" of its income, equal to the reserve addition, is in substance but a "deduction" allowed for that cost. Respondent then contends that a partial disallowance of what it assumes to be an otherwise allowable deduction, solely because of the receipt of tax-exempt interest, results in imposing a tax on that interest.

We are content to assume the relevance of respondent's analysis of the addition to the reserve in terms of cost but we challenge its assumption that viewed as an accruing cost the full addition to the reserve must be charged against the taxable gross income and none against the income from State bonds. As we now show, it is a fair and reasonable, and therefore constitutional, apportionment to limit the deduction from taxable income to that part of the "costs"—*i.e.*, to that part of the addition to the reserve—allocable to the production of the taxable income. We will then demonstrate that this is an *a fortiori* case because the special interests of the policyholders in the reserve furnish additional justification for the statutory formula.

763-293—65——4

1. *Treating the policyholders' reserve as a deduction for deferred costs, it is fair and reasonable to limit the deduction to that part of the costs allocable to the production of taxable income*

In order to analyze the Act and the reasonableness of its allocations in respondent's terms, it is necessary to restate the taxing formula in terms which accord with respondent's view of its function. In terms, starting with investment income, the Act allows an "exclusion" for the full amount of the addition to the reserve by setting it aside as the policyholders' share, plus a "deduction" for only a *pro rata* part of the tax-exempt interest (equal to the fraction that the "company's share" is of the total investment income). The result would be exactly the same; however, if the tax-exempt interest were first excluded in full and a "deduction" were then allowed only for that part of the addition to the reserve that the taxable income is of the total income—*i.e.*, with a deduction being allowed for only 90 percent of the addition to the reserve if only 90 percent of the investment income consists of taxable items.[11] The lat-

[11] If a company has an investment yield (y) of $100, tax-exempt interest (i) of $10, and a reserve addition (r) of $80, the Act would in terms allow an "exclusion" equal to the full amount of the reserve addition, $80 ($r$), plus a "deduction" for the "company's share" (20/100) of the tax-exempt interest, $2, thus allowing total exclusions or reductions of $82, and leaving $18, subject to tax.

If an exclusion is first allowed for the full amount of the tax-exempt interest, $10, and a deduction is then allowed for the same fraction (90/100) of the reserve addition ($80) as the taxable

ter is the computation that respondent sees as the substance of the statutory formula and which we will consider here.

The apportionment thus made is an entirely proper allocation of a cost of producing investment income between the taxable income and the income from State bonds. An insurance company produces income primarily by obtaining funds from policyholders (in the form of premiums) and investing them in income-producing assets. As the *quid pro quo* for its use of the policyholders' money, it undertakes to pay death benefits and other claims which exceed in amount the premiums it receives from policyholders. The excess of those ultimate liabilities over the premiums received is paid by the company in exchange for the use of the money which it invests and is the major "cost" incurred in the production of its investment income. Only if its investment income is greater than that cost is the company's business profitable. In determining

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income is of the total income, or $72, the result is the same; the exclusions or deductions total $82, and again only $18 is subject to tax.

Mathematicians will also readily perceive that the formulae for computing the total deductions or exclusions under the two approaches —i.*e.*, $(r+\left(\frac{y-r}{y}\right)i$, under the Act, and $i+\left(\frac{y-i}{y}\right)r$, under the "deduction" theory) are in fact mathematical equivalents, both reducing to $r+i-\left(\frac{r}{y}\right)i$.

The alternative methods of computation are set out in both tabular and graphic form in Appendix A (Schs. A and B and Chart), pp. 79–83, *infra*.

the company's net income from investments, therefore, a deduction ought plainly to be allowed for the payments it is required to make to policyholders. That is essentially what the 1959 Act, seen in respondent's terms, does. While the company's liabilities are deferred and need not be satisfied until the events occur entitling the policyholders to payment, the Act in effect allows the company to "accrue" the cost of using the funds paid in as premiums by allowing it to offset against its current income an addition to a reserve to reflect the maturing of the actuarially predicted policyholder claims. And since the funds so acquired are used to produce investment income, the addition to the reserve is a cost directly attributable to the production of the investment income.

If the company's investment income, earned at the "cost" of the annual addition to the reserve, were entirely from taxable securities, there would be no problem, and the cost would be deductible in full. In fact, the income is partly from taxable securities and partly from tax-exempt securities, and unless a deduction must be allowed against taxable income for the costs of producing tax-exempt income, it becomes appropriate, if not necessary, to allocate the cost between the two kinds of income produced by it. The solution adopted by the Act (restructured in respondent's terms) is the obvious and customary one: it allocates the cost in proportion to the amount of each kind of income produced by the investment of the funds. If 90 percent of the company's investment income is from taxable sources, 90 percent of the addition to the reserve is treated as a cost of producing taxable in-

come and a deduction in that amount is allowed. If only 70 percent of the investment income is taxable, only 70 percent of the reserve addition is deductible; the balance is treated as a cost of producing tax-exempt interest properly to be charged, not against the taxable income, but against the tax-free income it produces. Not only is that allocation perfectly reasonable but there is, we submit, no fairer method by which the allocation could be made. Certainly *some* part of the cost of using the policyholders' funds is attributable to the production of the tax-exempt interest, and unless Congress is constitutionally required to allow the costs of producing tax-exempt income to be offset against taxable income, so reasonable an allocation can hardly be subject to challenge.

The assumed constitutional prohibition against a federal tax on interest from State bonds does not require Congress, in providing for the computation of net income, to allow deductions from taxable income for items of expense that are fairly attributable to the production of non-taxable income from State bonds. There is no more reason why Congress should allow such a deduction for the costs of acquiring and holding State bonds (producing untaxed monetary income) than there is why it should allow a deduction for the costs of maintaining an automobile for personal use (producing untaxed real income). The explicit provision, contained in the revenue laws since 1934, disallowing any deduction for expenses "allocable" to tax-exempt interest (§ 265(1)) is no more special or discriminatory than is the provision explicitly disallowing "personal, living, or family ex-

penses" (§ 262). Both are manifestations of the general principle that deductions are usually allowed only for the cost of producing taxable income. The expenses of holding a State bond are not deductible, in short, for precisely the same reason that the expenses of maintaining a home, going on a vacation, or taking music lessons are not: they all belong to the great universe of expenses which lack the requisite nexus to the production of taxable income to justify charging them off as a cost of producing that income.

And just as no deduction at all need be allowed for expenses which are not attributable at all to the production of taxable income, so also a full deduction need not be allowed for expenses that are attributable only in part to the production of taxable income. As we have seen, the cost of an automobile that is used both to produce taxable income and for personal purposes may be allocated in proportion to the use of the automobile and the deduction may be limited to the portion allocated to its use for business purposes (see pp. 24–25, *supra*). By the same token, costs incurred to produce both taxable and tax-exempt income may be allocated in the proportion that they produce the two kinds of income and the deduction may be confined to the portion allocated to the production of the taxable income. Nothing in the constitutional doctrines pertaining to intergovernmental immunities requires Congress to allow a deduction from taxable income of the cost of producing income held constitutionally immune from federal tax.

Two decisions of this Court squarely sustain the foregoing proposition. *Denman* v. *Slayton*, 282 U.S.

514; *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371. The earlier cases are not to the contrary. For convenience we consider them all in chronological order.

In *National Life Ins. Co.* v. *United States*, 277 U.S. 508, the Court held unconstitutional provisions of the Revenue Act of 1921 which allowed a deduction for additions to the policyholders' reserves only to the extent that the additions exceeded tax-exempt interest from State bonds. The Court did not purport to condemn a limitation of an expense deduction to the part properly allocable as the cost of producing taxable, rather than tax-exempt, income, for the provisions of the Act suggested no such purpose. The Act suffered from the vice that instead of providing for a pro-rata allocation, it arbitrarily treated the costs of holding and using the reserve—the annual addition—as attributable first to the production of State bond interest to the full extent of that income and only the remainder as allocable to the taxable income. That was as arbitrary, in its way, as the respondent's claim that all the costs must be attributed only to the production of taxable income. The Court viewed the statute as merely a devious attempt to offset the immunity of interest from State bonds by denial of an *unrelated* deduction to the extent of the tax-exempt interest received and held only that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others." 277 U.S. at 522. The deduction allowed to others but disallowed to the recipient of State bond interest, to the extent

of that interest, was the fairly allocable share of the cost of producing the taxable income. It was therefore true to say that the insurance companies were being subjected to a higher tax upon their taxable income *merely* because they received income from State bonds. There is nothing in *National Life* inconsistent with our position in the present case. Here the fairly allocable share of the cost of producing the taxable income is allowed as a deduction and the tax is higher only because the receipt of income from State bonds makes it unfair to charge to taxable income the non-taxable income's fair share of the total investment cost.

In *Missouri Ins. Co.* v. *Gehner*, 281 U.S. 313, the Court did decide a question somewhat analogous to that presented here, holding that, in determining the taxable net worth of a corporation, a State could not apportion the corporation's liabilities between taxable and tax-exempt assets and then limit the deduction for liabilities to those allocable to taxable assets. Even if later cases had not removed any ground for claiming that *Gehner* invalidates a federal statute limiting expense deductions to the apportionable share of an over-all cost, we would believe that *Gehner* was distinguishable from the present case on a number of grounds: (i) it involved the invocation of the federal immunity from State taxation, an immunity which this Court has, since *McCulloch* v. *Maryland*, 4 Wheat. 316, 435–436, recognized to be broader than the immunity enjoyed by the State from federal taxation (see *New York* v. *United States*, 326 U.S. 572, 576–577); (ii) it concerned the scope of a federal im-

munity statute (31 U.S.C. 742) as well as the constitutional immunity,[12] and, indeed, has since been characterized by this Court as a decision based on that statute (*New Jersey Realty Title Ins. Co.* v. *Division of Tax Appeals,* 338 U.S. 665, 674); (iii) it did not present an issue of allocation of expenses between taxable and tax-exempt income, but rather an allocation of liabilities between taxable and tax-exempt assets; (iv) it involved a tax on property rather than one on income, which is important because a tax on income, unlike the tax on property, is already one step removed from the bonds themselves.

Whatever the merits of the *Gehner* ruling upon its own facts, two later decisions make it plain that neither *National Life* nor *Gehner* denies the power of Congress, in levying on taxable net income, to withhold a deduction for the expense of producing tax-exempt income and, in aid of that purpose, to limit the deduction of a single item of cost to the share fairly apportionable to the production of the taxable portion of the gross income.

In *Denman* v. *Slayton,* 282 U.S. 514, the taxpayer had $65,000 of income from State bonds and still larger income from taxable sources. From his taxable

[12] The broad scope of the federal immunity statute was confirmed by an amendment enacted in 1959 to make it clear that (73 Stat. 622):

> "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except non-discriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes."

income he subtracted $78,000 paid as interest on money borrowed for the purpose of purchasing the State bonds. The Commissioner disallowed the deduction under a statutory provision (now § 265(2)) permitting the deduction of interest paid on indebtedness "except on indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title * * *." 282 U.S. at 518. The taxpayer, relying upon *National Life* and *Gehner*, argued that the denial of the deduction violated the constitutional immunity of the income from State bonds because the taxpayer had been subjected to greater tax burdens by reason of their ownership. The Court sustained the Commissioner, ignoring *Gehner* and distinguishing *National Life*. Obviously the case holds that the exclusion of State-bond interest from the computation of net income subject to tax makes it permissible also to exclude from the computation the cost of producing the non-taxable interest.

Since the expense involved in *Denman* v. *Slayton* was incurred specifically and solely to produce the tax-exempt income, that case did not involve the apportionment of a single item of expense incurred in producing both taxable and tax-exempt income. The underlying principle, however, is the same in both cases. If one obtains a single loan of $100,000 and uses half to buy corporate stocks and half to buy State bonds, only half the interest paid on the loan need be allowed as a deduction; the other half is no more fairly deductible from the income from the stocks than it would be if one obtained two separate loans of

$50,000 and used one for the sole and specific purpose of purchasing State bonds.

Three Terms later, in *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, the underlying principle of *Denman* v. *Slayton* was applied to the apportionment of a single item of expense. The Revenue Act of 1921 taxed only a life insurance company's income from interest, dividends, and rentals, and it allowed deductions for taxes, depreciation, or other expenses paid on real estate held for rental. The Act specifically denied those deductions, however, if any part of the rental property was occupied by the company itself, unless the company included in gross income a figure for the rental value of the space it occupied sufficient to provide a net income from the building equal to 4 percent of the book value of the whole building. The company argued and the Court agreed that a tax on the rental value of property the company owned and used would be unconstitutional "for that would be to lay a direct tax requiring apportionment." 292 U.S. at 378. Moreover, the statute plainly increased the company's taxable income by denying all or part of an expense deduction if it chose to use part of a building it owned and rented. Nevertheless, the Court rejected the company's argument, based on *National Life*, that the statute imposed an unconstitutional tax on the rental value of the owner's use of his own building. The Court held that the tax-exempt rental value of the space occupied by the company could be used to apportion between taxable and tax-exempt income the otherwise wholly deductible expenses for maintaining the building (at p. 380):

> The statute does not prescribe any basis for the apportionment of expenses between space used by the company and that for which it receives rent. The calculation indicated [the use of imputed rental value of the space occupied by the company] operates as such an apportionment where the rents received are more than four per cent of book value, but less than that amount plus expenses. In such cases the addition, called rental value of space occupied by the company, is employed to permit a deduction on account of expenses. * * *

To sustain the propriety of limiting a deduction by an apportionment of an item of expense the Court likened the issue before it to the exemption for income from State bonds and invoked the decision in *Denman* v. *Slayton* holding that Congress can limit an expense deduction by eliminating the amount attributable to tax-exempt income. Accordingly, the Court concluded, the statute did "not lay a tax upon respondent's building or the rental value of the space occupied by it or upon any part of either" (292 U.S. at 381). Once again the *National Life* case was distinguished and *Missouri* v. *Gehner* was ignored.[13]

[13] The 1959 Act contains a provision similar to that of the 1921 Act. In determining "investment yield," a life insurance company is allowed deductions for real estate expenses and depreciation. § 804(c) (2) and (3). The deductions are limited, however, "to an amount which bears the same ratio" to the total expenses "as the rental value of the space" not occupied by the company for insurance purposes "bears to the rental value of the entire property." § 804(c)(3). This continuing provision for the taxation of insurance companies, which differs from that in the *Independent Life* case only in that the present method of apportionment is more equitable, has not been challenged since the *Independent Life* case.

Decisions in related areas also show that property or income constitutionally immune as the subject of a tax may be included in making a fair apportionment as part of the computation of a tax on a proper subject, even though the effect is to increase the tax. For example, in taxing the part of a company's net income apportionable to business done within its borders a State may take into account extra-State sales which, so far as it is concerned, are constitutionally immune from tax; and this is true even though the result of an increase in the immune extra-State sales, all other things being equal, is the payment of a higher State tax. *E.g., Butler Brothers* v. *McColgan,* 315 U.S. 501; *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113; *Northwest Cement Co.* v. *Minnesota,* 358 U.S. 450. And, of course, every decision sustaining an apportionment of net income between taxable sources and non-taxable sources, such as out-of-State business, is in effect an apportionment of items of expense limiting the deductions made from gross receipts from taxable sources. *E.g., United States Glue Co.* v. *Town of Oak Creek,* 247 U.S. 321. Except for the *Gehner* decision, the law has always been the same for taxes measured by the value of property. *Maxwell* v. *Bugbee,* 250 U.S. 525. Thus, while Texas cannot constitutionally tax real property located in Michigan (*Western Union Telegraph Co.* v. *Kansas,* 216 U.S. 1; *Cream of Wheat Co.* v. *County of Grand Forks,* 253 U.S. 325), it can take into account the value of such real property in determining the total net worth of a corporation, a fairly apportioned part of which Texas may tax. *Ford Motor Co.* v. *Beau-*

champ, 308 U.S. 331; *International Harvester Co.* v. *Evatt*, 329 U.S. 416. The fact that the Texas tax is increased by the ownership of an additional factory in Michigan does not mean that Texas is taxing real property in Michigan. It is, of course, equally clear that, in taxing the part of the net worth of a corporation which is properly allocable to the taxing State, a fairly apportioned part of the liabilities of the corporation may be denied a deduction because it is attributable to constitutionally immune property in other States (*ibid.*).

In short, the principles applied by Congress in the Life Insurance Company Income Tax Act of 1959 and sustained by this Court in the *Independent Life* case are merely the established doctrines regularly applied by the Court where it has been called upon to determine whether a tax has been imposed on constitutionally immune income or property. Their application to the present case is neither novel nor debatable.

Those principles control the present case. If the reserve exclusion in the Life Insurance Company Income Tax Act of 1959 is treated, as respondent contends it should be, as a deduction for one of the costs of producing the company's total investment income, then the *Independent Life* case is dispositive of the power of Congress to limit the deduction by allocating part of the cost to the tax-exempt income the company receives. Just as the tax-exempt rental value of the part of its property occupied by the Independent Life Insurance Company could properly be taken into account to limit the deduction for the costs of maintaining the building to the portion of the costs fairly

allocable to the production of taxable rental income, so can the tax-exempt interest realized by respondent properly be taken into account to limit the deduction for the cost of producing its investment income (the required addition to the reserve) to the portion fairly allocable—by an allocation formula far more reasonable than that used in *Independent Life*—to the production of taxable investment income. In one case a deduction is reduced because it is partly allocable to an owner's tax-exempt use of his own property; in the other, a deduction is limited because it is partly allocable to the receipt of tax-exempt interest. And just as the *Independent Life* case involved no tax on the rental value of the property used by the owner, the present case involves no tax on the interest from State bonds.

2. The special interests of the policyholders in the reserve furnish additional justification for the apportionment

Although it is enough to sustain our case to show that the computations prescribed by the 1959 Act make a fair apportionment of the annual addition to the policyholders' reserve treating the addition as a cost or expense, we submit that, in truth, the reserve has characteristics which make this a far stronger case for upholding the apportionment and resulting limitation on the deduction from gross taxable income. For while the policyholders are neither the legal nor equitable owners of the reserve, it is created to protect them, and is treated by the industry as a special fund for their benefit, to such an extent as to make the tax treatment of annual additions to the

reserve fairly analogous to the problems arising upon the distribution to two or more beneficiaries of income from taxable and tax-exempt sources.

Congress' conception, as we have seen, was that the undivided part of the insurance company's assets represented by the policyholder reserves constitutes a "trust fund" held for the ultimate benefit of the policyholders, and therefore, for tax purposes, it should be treated as a separate entity from the "company." Congress accordingly treated the required annual addition to the reserve simply as a division between two entities of the income earned from the investment of their commingled assets, the share going to the "trust fund" for the benefit of the policyholders being described as the "policyholders' share" and the share going to the "company" being described as the "company's share." The "policyholders' share" of the income, in short, was "excluded" from the company's tax base, not because it was thought of as a deductible cost, but because, on Congress' conception of the nature of the reserve funds, it was simply not "the company's" income.[14] The computations resulting from this approach are somewhat different from those resulting from treating the addition as an item of cost

[14] The income added to the reserves was not taxed to the "trust fund" itself, regarded as a separate taxable entity, presumably because of a judgment of tax policy that it was desirable to permit a tax-free accumulation of funds to finance death benefits. Compare the exemptions accorded to qualified employee pension trusts (§§ 401–404, 501(a)) and to various kinds of fraternal, employee, and benevolent associations which provide accident or death benefits (§ 501(c) (8)–(12)).

but, since both lead to the same result,[15] proof of the fairness and constitutionality of the one tends to confirm the fairness and constitutionality of the other.

The distinctive character of policyholder reserves which was recognized by Congress derives primarily from their treatment under State law. In order to protect policyholders from putting their life's savings into insurance policies only to find an empty barrel when their claims fall due, life insurance companies are generally required under State law to retain on hand at all times net assets at least equal to their reserves for policyholder liabilities computed on prescribed mortality and interest assumptions. The type of investments insurance companies may make with their reserve funds is also closely regulated by State law. Inasmuch as the reserves required to be maintained increase each year by the rate of interest assumed in computing the reserves, the company is required each year to increase the amount of the net assets it retains on hand. As a practical matter, that increase can come only from the income earned from the investment of the assets. The practical result of the State regulation, then, is that a part of the income received each year (equal to the required interest on the reserve) is "frozen"; it is not available for distribution but must be held back and placed in legal investments in order to assure the ability of the company to pay the policyholder claims as they fall due.

The extensive protection thus afforded the policyholders' interests under State law, and the practical

[15] Indeed, they reduce mathematically to the same formula. See p. 33, *supra*.

interest the policyholders have in the income yield from the assets (necessary in order to maintain the increasing reserve), have led to a widespread characterization of the undivided part of the assets equal to the reserves as a "trust fund" held for the benefit of the policyholders which does not beneficially "belong" to the company, at least in a practical, economic sense.[16] Thus the Institute of Life Insurance refers to the reserve funds (*i.e.*, the undivided part of the assets counterbalancing the reserve liability) as the "policyholders' funds,"[17] and standard texts speak of the reserve as a fund which "does not belong to the company but is held in trust for the policyholder at an assumed rate of interest."[18] Leading judicial opinions have for many years spoken in a similar vein, and Judge Learned Hand has described policyholders as "associates" in the "financial operations of the whole group, which thus makes profits or losses as such."[19]

To be sure, the restrictions imposed by State law on what an insurance company may do with the share of its assets equal to the reserves do not, under traditional concepts, amount to a change in the "own-

[16] *Wurzel, Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L.J., 15, 40–44.

[17] Institute of Life Insurance, *Life Insurance Fact Book*, 1959, pp. 61–64.

[18] Huebner & Black, *Life Insurance*, p. 6.

[19] *New York Life Ins. Co.* v. *Bowers*, 39 F. 2d 557, 558–559 (C.A. 2), affirmed, 283 U.S. 242; see also *Penn Mutual Co.* v. *Lederer*, 252 U.S. 523, 534.

ership" of the assets. They do, however, establish a significant difference in the capacity in which the company holds the two shares of the assets (the undivided share equal to the reserves and the balance). The basic policy judgment made by Congress was that income which is accumulated and held for the payment of death benefits to policyholders ought to be exempt from tax but that income received by an insurance company which is free of the requirement that it be held for the benefit of the policyholders ought to be taxed. Having made that judgment, it was patently reasonable for Congress, in the light of the significant difference in the restrictions imposed by State law on the company's use of the two shares of its assets and income, to treat the company as acting in a dual capacity and then to exempt the income received by it in one capacity (the income required to be held for the benefit of the policyholders) while taxing the income received in the other (the income free of the restrictions imposed by State law). While the capacity in which a life insurance company holds the undivided share of its assets equal to the policyholder reserves may not technically be that of a "trustee" under common-law concepts, Congress is no more bound by common-law concepts in determining what it will recognize as separate entities for tax purposes (here, the company *qua* holder of the reserve funds and the company *qua* holder of the remaining assets) than it is in determining what it will recognize as "ownership". Cf. *Burnet* v. *Wells*, 289 U.S. 670; *Corliss* v. *Bowers*,

281 U.S. 376; *Reinecke* v. *Smith*, 289 U.S. 172.[20] There being a real difference in the company's relationship to the two shares of its assets, Congress, in order to further its policy of permitting a tax-free accumulation of income for purposes of paying death benefits, could properly view a life insurance company as constituting a dual entity and tax it accordingly.

Having excluded a share of the investment income from the tax base on the theory that it constituted a "division" of the income between what it regarded as two distinct entities—one tax-exempt (the "trust fund" for the policyholders) and the other taxable (the "company")—it was plainly reasonable for Congress to treat the two shares of the income as consist-

[20] In *Burnet* v. *Wells*, in upholding a tax on the settlor of a trust on the income of the trust used to pay premiums on insurance policies on his life, Mr. Justice Cardozo set forth the applicable constitutional standards in terms equally applicable here (pp. 678–679):

> Refinements of title are without controlling force when a statute, unmistakable in meaning, is assailed by a taxpayer as overpassing the bounds of reason, an exercise by the lawmakers of arbitrary power. In such circumstances the question is no longer whether the concept of ownership reflected in the statute is to be squared with the concept embodied, more or less vaguely, in common law traditions. The question is whether it is one that an enlightened legislator might act upon without affront to justice. * * * To overcome this statute the taxpayer must show that in attributing to him the ownership of the income of the trusts, or something fairly to be dealt with as equivalent to ownership, the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit. * * *

ing of a pro rata share of each item of income. That is the method of allocation that has long been utilized, without challenge, to solve the analogous problem of dividing the income of a trust among the several beneficiaries (see pp. 26–27, *supra*), and there is even more justification for its use here. Since the "corpus" of the "trust fund" for the policyholders consists of an undivided share of all the assets, it necessarily contributes equally to the production of all of the kinds of income derived from the investment of those assets. Thus the allocation of a pro rata share of all the income to the policyholders' reserves is justified, not only because of the lack of any more rational basis for allocation (as in the trust case), but also because the reserve funds in fact contribute equally to its production.

Respondent argues that the statute's treatment of the addition to the policyholder reserves as a "division" of income, with an "exclusion" then being allowed for the "policyholders' share," is mere sleight-of-hand, a use of labels invented by Congress in an effort, while accomplishing the same substantive results, to avoid the constitutional difficulties that would (in respondent's view) be presented by a partial disallowance of the "deduction" for the reserve addition because of the receipt of tax-exempt interest. We do not pause to answer the criticism of the statutory terms because as we have shown (pp. 32–45, *supra*) the supposed constitutional difficulties arising from the treatment of the reserve addition as a "deduction" do not exist, and the apportionment prescribed by Congress would be constitutional even if the analysis

in terms of cost were a full and accurate portrayal. The truth would seem to be that respondent's description is incomplete because it overlooks the special characteristics of the policyholders' reserve, just as the analogy to trust income may be imperfect because the policyholders have no property interest. There is no occasion to debate which analogy is the more persuasive. Both lead to the same conclusion—that there is no tax on a life insurance company's income from State bonds violating the assumed constitutional limitation—and therefore each approach tends to show the fairness of the other.

II

SINCE THE STATUTORY APPORTIONMENT DOES NOT VIOLATE THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON STATE-BOND INTEREST, THE "EXCEPTION CLAUSES" ARE INOPERATIVE

By express enactment the "exception clauses" invoked by respondent (§§ 804(a)(6), 809(b)(4)) are inoperative only if it is established that the statutory formula—

> results in the imposition of a tax on—
>
> (A) Any interest which under section 103 is excluded from gross income [*i.e.*, interest from State bonds] * * *

If the effect of this provision is to require adjustment only where the statutory formula results in the imposition of a tax on State-bond interest in the sense that the tax could not be sustained consistently with the once-established basic consitutional immunity of State-bond interest from federal tax, then the provision is inoperable in the present case because, as we

have seen, the formula does not violate the assumed constitutional prohibition. If the exception clauses have some other meaning, the task remains of establishing that meaning and determining whether the case falls within it.

In our view the function of the exception is only to provide for an adjustment if the statutory formula cannot be applied consistently with the established constitutional immunity of State bonds. In every statute taxing life insurance companies since 1921 Congress has recognized that the annual addition to the policyholders' reserves, for all of which a deduction or exclusion is allowed, consists in part of tax-exempt income, and that to allow both to be deducted or excluded in full is to make a double allowance. The Revenue Act of 1942 attempted to avoid the duplication on an industry-wide basis by reducing the deduction for the reserve in the proportion that the tax-exempt interest received by the whole industry bore to its total investment yield. 56 Stat. 870. When it was proposed to replace the industry-wide method of computing the reserve deduction by a company calculation, several formulae, including the formula ultimately incorporated in the 1959 Act, were advanced for the express purpose of preventing a double allowance.[21] Life insurance companies holding more than 70 percent of all life insurance company assets in the United States agreed that the apportionment ultimately incorporated into the statute

[21] Compare H.R. 4245, 86th Cong., 1st Sess., with the statute as enacted.

should be adopted [22] but others disagreed and the opponents of the formula contended that it imposed an unconstitutional tax on interest from State bonds.[23] As we show below in detailing the legislative history, not only did they believe that the tax was on State bonds, but they feared that, to sustain it, the Treasury might attack the basic doctrine that a tax on State-bond interest is unconstitutional. The Treasury denied that the formula imposed a tax on State-bond interest or that it had any such intent. As we see it, Congress in enacting the exception clause barred an attack upon the basic constitutional immunity but left the subsidiary question to the courts by providing for an adjustment in the event that its formula and the basic constitutional immunity could not survive together because, in the constitutional sense, the tax was imposed "on" the interest.

Respondents argued in the court below that Congress set up its own standard for determining whether a tax was on State-bond interest. The test prescribed, they said, was to ask whether under the statutory formula the tax would have been lower but for the receipt of the income from State bonds. We submit that this interpretation is untenable on the face of the statute, and that the legislative history as well as the interrelationship between the formula and "exception" clause shows our interpretation to be correct.

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[22] 105 Cong. Rec. 8402. See *infra*, p. 74.

[23] See *infra*, p. 65.

A. THE INTERRELATIONSHIP BETWEEN THE SEVERAL PARTS OF THE STATUTE SHOWS THAT THE FUNCTION OF THE EXCEPTION CLAUSE IS TO PROVIDE AN ADJUSTMENT ONLY IF THE STATUTORY FORMULA VIOLATES THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

The inclusion of both the apportionment formula and the "exception" clause in the same statute makes it apparent that the "exception" clause must refer to some external standard for determining whether the formula imposes a tax upon interest from State bonds. The most likely standard—looking only to the face of the 1959 Act—is the body of constitutional law developing the principle that the federal government has no power to tax State borrowing. The likely occasion for incorporating the constitutional doctrine into the statute was the risk, which Congress desired to obviate, that if the formula were held to impose a tax upon State-bond interest, contrary to the congressional expectation, the Treasury would seek to sustain it by asking the Court to overrule the basic constitutional immunity.

If Congress had had some independent but self-contained standard in mind, it would surely have decided for itself whether the apportionment formula or the standard provided by the exception should prevail. There was no mystery about the operation of the specific formula which Congress wrote into the law and for which it expressed a preference if the formula could be reconciled with some other standard which Congress regarded as superior but about the application of which it was uncertain. If Congress had had a specific, self-willed standard in mind,

it would have known better than anyone else whether that standard was consistent with the formula and, if it was inconsistent, Congress could, and undoubtedly would, have decided which of the two should prevail. It would have been idle for Congress to instruct the courts to determine whether what it clearly enacted in one part of a statute is inconsistent with what it "intended" to enact as some wholly internal self-contained standard in another part; for the question would reduce itself to an inquiry whether Congress intended what it did.[24] The only intelligible explanation of the co-existence of the two provisions is the one we suggest: that Congress intended to make the formula effective if it could be done consistently with some superior external standard with which the courts were more familiar than the Congress and whose application to the circumstances was the subject of congressional debate. The most natural point of reference having those characteristics is the body of constitutional law described above.

The bizarre implications of imputing to Congress a purpose to adopt its own independent standard of

[24] We are not dealing here with a situation in which an enacted formula, although operational in the generality of cases as enacted, may in a few specific applications run counter to the policy expressed by Congress in another provision. The formula governing the allowances or deductions from a life insurance company's investment income operate in the same manner and the exception clause comes into play to the same extent, if at all, in every case in which the company receives State-bond interest; and State-bond interest is expressly mentioned in the apportionment formula. Accordingly, this cannot be analyzed as a case in which Congress was guarding against occasional contingencies that might arise but were not part of the generality of the cases with which it was dealing.

what a tax is "on" are sharply illustrated by the particular standard respondent attributes to Congress—namely, the "but-for" test employed by the court below. With that standard read into the "exception" clause as a specific statutory directive understood by Congress, the Act is reduced to saying: (1) the tax shall be equal to the tax rate times an amount equal to

> taxable income *plus* tax-exempt interest *minus* reserve addition *minus* company's share of tax-exempt interest

"except" that (2) the tax shall not be greater than it would be if the tax-exempt interest were zero. The result, of course, is self-contradiction. Wherever there is tax-exempt interest the tax under (1) will be greater than if there were none because the total amount of tax-exempt interest, if there is any, will always be greater than the company's share. If Congress had "wanted" the tax to be no greater than it would be if the company had not received the tax-exempt interest, it had only to eliminate the tax-exempt interest from the formula. No rational body would consciously set out to accomplish that result by repealing in one provision what it enacted in another.

Since Congress could not actually have intended both what the taxing provisions expressly say—that tax-exempt interest shall be taken into account—and what respondent claims the "exception" clause means—that the tax-exempt interest shall not be taken into account—respondent seeks to avoid the dilemma by asserting that Congress did not "understand" the taxing formula and how it would operate

(Br. in Opp. 9–10). That is, in order to conclude that Congress meant by the "exception" clause something which it did not say—that a tax should be deemed to be imposed "on" tax-exempt interest whenever the tax is higher because of the interest, regardless of the reasonableness of the allocation used—the Court is asked to hold that Congress did not understand what it did say in the taxing provisions.

The suggestion that Congress did not understand that the result of treating a share of the tax-exempt interest as going into the policyholder reserves and allowing the company to deduct (in addition to the reserve exclusion) only a fraction of the tax-exempt interest would be to cause the tax to be higher than if the tax-exempt interest were disregarded altogether, is wholly unacceptable. The courts cannot say that Congress did not understand the meaning—the only meaning—of its own enactment. Congress enacted the definitions of "gain from operations" and "taxable investment income" into law, and there is no dispute about what those provisions expressly say. It would be a slander on the legislative process for us to undertake to prove, or for the courts to inquire, whether Congress "understood" what the definitions unquestionably say about every situation they cover. The "exception" clauses permit of only one interpretation which gives them a function rationally consistent with the enactment of the formula—they refer to the external constitutional principles determining whether a tax is on State-bond interest as this Court would apply them. The meaning of the "exception" clauses is therefore fixed by a presumption of law—*i.e.*, a

conclusive presumption—that Congress acted rationally and not from schizophrenia in simultaneously enacting the two sections.

We should acknowledge one logically possible exception: it is rationally conceivable that Congress intended to refer, for an external standard, not to the whole body of constitutional law relevant to whether a tax is "on" State-bond interest but only to a few selected decisions to be interpreted in isolation without regard to other equally material precedents; and respondent would find such decisions in *National Life Ins. Co.* v. *United States*, 277 U.S. 508, and *Missouri* v. *Gehner*, 281 U.S. 313. Such legislative conduct, while conceivable, is utterly implausible. If Congress had understood those particular decisions to lay down the "but for" rule, it would hardly have enacted the exception clause; the only sensible course would have been to modify or abandon the apportionment formula. If there was debate about the meaning of those decisions and if Congress intended the standard to be derived from reading them in isolation, then it would have written the "exception" clause so as to refer to the specific cases, instead of adopting a general concept developed in a whole series of decisions. Under our legal system, moreover, the effect of any particular precedent is determined, not by exegesis from the opinion as an isolated document, but by appraising its significance in the context of the body of law of which it is a part. In other words, Congress undoubtedly referred to existing law but the existing law is a living growing body of principles derived not only from the *National Life* and *Gehner*

cases but also from the other precedents discussed in Point I. Judged by existing law in that most meaningful sense, the apportionment formula does not impose a tax "on" interest from State bonds.

There is nothing to the contrary in *Helvering* v. *Griffiths,* 318 U.S. 371, where the Court held that the Internal Revenue Act of 1936 did not invite reconsideration of *Eisner* v. *Macomber,* 252 U.S. 189, even though the statute taxed all "dividends" with the proviso that a stock dividend was not to "be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment." 53 Stat. 47. The question was whether the quoted provision intended to incorporate the "existing constitutional law" or imposed a tax which was condemned by *Eisner* v. *Macomber* but which might be found constitutional upon reconsideration of that decision. The background of the provision was this: After the decision in *Eisner* v. *Macomber,* Congress, supposing the decision to imply that no stock dividends were taxable (even though the case involved only a common-on-common dividend), had itself excluded all stock dividends from taxable income. Later decisions, in different contexts, showed that *Eisner* v. *Macomber* should not be read so broadly. The primary purpose of the new provision in the Revenue Act of 1936 was to discard the exclusion and include in taxable income all the kinds of stock dividends which, under the subsequent decisions, were distinguishable from the common-on-common dividends involved in *Eisner* v. *Macomber.* Admittedly, there was no thought at

the time that the actual holding in *Eisner* v. *Macomber* could be successfully challenged. It was only after two decisions in 1940 had still further undermined the theoretical basis of *Eisner* v. *Macomber* that the Treasury changed the regulations and asserted that the Revenue Act of 1936 required common-on-common dividends to be included in taxable income. When that question came before this Court, the Court held that the very general language of the 1936 Act, which admittedly had another purpose and could be given another effective meaning without reaching common-on-common dividends, was not sufficient to show an intent to tax the very dividends that *Eisner* v. *Macomber* had held cannot be taxed. 318 U.S. at 394.

The Life Insurance Company Income Tax Act of 1959 is wholly unlike the provision at issue in *Griffiths* because Congress, in the detailed definitions of "gain from operations" and "taxable investment income" in the 1959 Act, prescribed in explicit words the precise manner in which tax-exempt income is to be taken into account. It incorporates the existing body of constitutional law as an overriding standard, if inconsistent, only in a "caveat" authorizing an "adjustment." In *Griffiths*, there was nothing in the statute flatly inconsistent with Congress' not wanting to tax common-on-common dividends and the question was therefore whether it had in fact "wanted" to tax them. Here, the explicit statutory formula is directly inconsistent with the hypothesis that Congress did not want the tax to be increased because

of tax-exempt interest no matter what the appropriate apportionment, and the question is therefore not whether Congress "wanted" that result but only whether its specifically-affirmed objective is inconsistent with assumed constitutional limitations Congress wanted to respect. In *Griffiths,* the Treasury was seeking to overrule a leading constitutional precedent. Here, putting the question most favorably to respondent, we are arguing only that *National Life* and *Gehner* must be read together with such equally important cases as *Denman* v. *Slayton, Helvering* v. *Independent Life Ins. Co.,* and other cases in the body of constitutional law of which they were a part.

In short, the very words of the statute and the interrelationship between the exception and the provisions establishing the formula compel the conclusion that Congress intended an adjustment only if the formula that it specifically prescribed was inconsistent with constitutional standards for determining whether a tax is imposed upon State bonds.

B. THE LEGISLATIVE HISTORY SHOWS THAT THE FUNCTION OF THE EXCEPTION CLAUSE IS TO PROVIDE AN ADJUSTMENT ONLY IF THE STATUTORY FORMULA VIOLATES THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

As noted above, in every statute taxing insurance companies since 1921 Congress has recognized that additions to policyholders' reserves consist in part of (or are in part a cost of producing) tax-exempt income and, therefore, that to allow the reserve addition and the tax-exempt interest both to be deducted in full from the investment income would result in duplicating deductions. Under the Revenue Act of

1942, the duplication was sought to be eliminated by allowing a reserve deduction equal to a fixed percentage of each company's investment income but computing the percentage on an industry-wide basis under a formula which reduced the deduction in proportion to the extent that industry's investment income consisted of tax-exempt interest. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 107–108; S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 142–143. The major change made by the 1959 Act was that the industry-wide method of computing the reserve deduction was eliminated and each company was treated individually.

The House bill (H.R. 4245), like the 1942 Act, allowed a "deduction" for the reserve addition but required that the deduction be reduced in the proportion that the company's tax-exempt interest (and the excludible portions of two other types of income) bore to its total investment income. The House Ways and Means Committee explained (H. Rep. No. 34, 86th Cong., 1st Sess., p. 11):

> To prevent this double allowance with respect to these amounts, the bill makes a reduction in the policy and other contract liability deduction for the portion of this deduction attributable to these three types of excluded or deducted income. *This does not, however, impose any tax on the exempt interest,* on 30/52ds of partially tax-exempt interest, or 85 percent of dividends received from domestic corporations. [Emphasis supplied.]

As the italicized portion indicates, the House Committee determined to its own satisfaction that the House

bill did not impose a tax on exempt interest, notwithstanding that it reduced a deduction and thus increased the tax when a company received tax-exempt interest.

During the Senate Finance Committee hearings on the House bill, the effect of the formula for reducing the reserve deduction to reflect the pro rata portion attributable to tax-exempt interest and other exempt income was fully explored from every aspect and fully debated by Senators and witnesses. Three points merit emphasis. First, and most important, it was made overwhelmingly clear to the Committee members that a necessary result of the statute was a reduction of the reserve deduction and thus an increase in the company's tax when it received an increment in interest from State bonds. *Hearings on H.R. 4245 before the Senate Finance Committee, 86th Cong., 1st Sess.* (hereinafter *"Senate Hearings"*) pp. 45, 46, 187, 253–254, 266–267, 310–313, 405, 414–415, 516–518, 613–614, 694–695. Second, it was repeatedly emphasized that a formula which caused the tax to be increased with the receipt of tax-exempt interest would necessarily reduce the tax advantages of owning State bonds and thus reduce the companies' incentive to buy such bonds.[25] *Id.* at 187, 252, 254, 267, 310–313, 405, 414–

[25] There is, we should note, nothing mysterious about the effect of the 1959 Act on a company's incentive to buy tax-exempt bonds. A fully taxable taxpayer derives the greatest benefit from tax-exempt items of income. A charity, being wholly exempt from tax anyway, derives no benefit and has no reason to prefer tax-exempt bonds over industrial bonds. Under the 1959 Act, a life insurance company is taxed only on, say, 20% of its income and is thus in effect an 80% tax-

415, 613–614, 687–690; see also, 45–47, 121–122; *cf.* 252–266 (tax on dividends). There was disagreement as to the extent of the effect and as to the wisdom and fairness of the result, but none as to the reality of the effect on the investment decisions of insurers.

As to the correctness of these two factual matters there was neither question nor dispute. As to the third subject of discussion, the question of constitutionality, there was plainly disagreement. Senator Butler and a number of insurance industry witnesses, relying on this Court's decisions in *National Life* and *Gehner,* contended that any reduction in the reserve deduction necessarily resulted in a tax on interest from State bonds in conflict with their traditional constitutional immunity. *Senate Hearings,* pp. 43–44, 305–318, 407–408, 516–518, 613–614, 700–702. Mr. Lindsay, Assistant to the Secretary of the Treasury, agreed with the House Ways and Means Committee that the bill could not be characterized as imposing a tax on tax-exempt interest, inasmuch as it merely charged a fair share of the company's major investment cost against the tax-exempt interest it helped to produce. *Id.* at 43, 44–51, 59. Most members of the Finance Committee apparently agreed. See the statement of Senator Curtis, quoted below (p. 68), who was chosen to explain the Committee bill to the Senate, and the statements of Senator Byrd, Chairman of the

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exempt taxpayer. Being taxable on only 20% of its income anyway, it derives correspondingly less benefit from shifting some of its income from taxable to tax-exempt sources, and thus has less incentive to buy State bonds than would a fully taxable entity.

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Committee, at 105 Cong. Rec. 8401 and 10400. The representatives of the States and their subdivisions wavered between the two positions, although they fully understood the tax and economic consequences of the House bill. *Senate Hearings,* pp. 121–122, 122–123, 699–700.

Perhaps most important for an understanding of the origin and purpose of the "exception" clauses was the disagreement between Senator Butler and Mr. Lindsay as to the proper method of resolving their dispute as to the constitutionality of the bill. Mr. Lindsay stated, "I feel that we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill," although the "question might very well be litigated." *Id.* at 43–44. Senator Butler apparently thought that the Treasury's arguments that the bill did not tax interest from State bonds were disingenuous. In a supplemental memorandum filed with the Committee he asked (*id.* at 702):

> What, then, is the Treasury Department's real purpose in proposing this formula? The answer is readily apparent. Stated simply, the Treasury wants to "buy" a lawsuit. If Congress can be persuaded to approve this formula, then hopefully some insurance company will then be tempted to contest the levy on constitutional grounds. The Treasury has been waiting for this opportunity for years. The arguments are prepared. All that is needed is the legal controversy which will lead to Su-

preme Court review of the *National Life* and *Missouri* v. *Gehner* cases.

The Treasury seems convinced that the Supreme Court in such a case would not only uphold this partial tax on tax-exempt bonds held by life insurance companies, but more particularly, would strike down the whole tax-exempt doctrine by reversing these previous decisions. I view in the gravest terms the Treasury Department's resort to this circuitous route to achieve what, in effect, amounts to a constitutional amendment, especially in a matter so important to our Nation's basic structure. Certainly, in a matter of this kind, the consent of Congress on the direct issue involved and ratification by the States would appear essential.

Following the hearings, the Senate Finance Committee recommended two changes in the House bill: (1) the reformulation of the provisions to account for the addition to the reserves by an "exclusion" of the "policyholders' share" of the income rather than by a "deduction" and (2) the addition of the "exception" clause. The substance of the House taxing formula was maintained; the Senate provisions dividing each item of income between the excluded "policyholders' share" and the "company's share" produced mathematical and economic results substantially the same as those produced by the House provisions reducing the reserve "deduction" in proportion to the exempt character of the company's income.

As explained in the Committee report and by the Committee spokesman on the floor (Senator Curtis), a primary purpose of the division of investment income

between the "policyholders' share" and the "company's share" was to state, in the clearest form possible, the Committee's view as to why tax-exempt interest should be considered in determining the amount of the exemption for the reserve for policyholders and why the result was not to tax tax-exempt interest. Senator Curtis said that the problem of accommodating the exemptions for the policyholders' reserves and interest from State bonds while not taxing tax-exempt interest was "a matter which has deeply concerned your committees" (105 Cong. Rec. 8429):

> * * *. The bill meets that problem most accurately and fairly. It provides for a division of all items of investment income—referred to in the bill as "investment yield"—into what are called the "policyholder's share" and the "life insurance company's share." The "policyholder's share" * * * is exempt from tax. * * * [A]ll items of tax-exempt income and credits are appropriately divided between the part of the investment income that is to be subjected to tax and the part that is not; and a full, complete deduction is allowed, in computing the net taxable portion, for all tax-exempt interest—and credits—attributable to the taxable portion of the investment income.

The Finance Committee Report is equally explicit in justifying the Committee's view that its treatment did not result in imposing a tax on tax-exempt interest. After explaining how the House bill reduced the reserve deduction to reflect tax-exempt income, it stated (S. Rep. No. 291, 86th Cong., 1st Sess., p. 6):

> Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt or deductible, such as tax-exempt State and municipal bond interest, partially tax-exempt Federal bond interest, and 85 percent of intercorporate dividends received, are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items.

Simultaneously the "exception" clause was added. The Senate Report merely paraphrases the provisions without explanation. The floor debates in the Senate and House of Representatives are somewhat more instructive. Two closely related points emerge. First, there was absolutely no suggestion that the "exception" clause was to be an integral and generally operative part of the taxing formulae; the operation of the statute was always described without them. Second, the "exception" clause was rather plainly intended to come into play only if Congress had been mistaken in its judgment that the general taxing formula did not tax exempt interest. Thus, when asked if it was correct that "county and municipal bonds will not be taxed under the bill," Senator Byrd, Chairman of the Senate Finance Committee, responded (105 Cong. Rec. 10400): "That is my construction. There is a proviso that if by any chance

under the bill they should be taxed, necessary steps will be taken to refund the tax." He had earlier explained (105 Cong. Rec. 8401):

> In providing the formula I have described to the Senate it was the intention of the committee not to impose any tax on tax-exempt interest. The Treasury has assured the committee that this formula does not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so.

Representative Mills, Chairman of the House Ways and Means Committee, expressed a similar understanding that the statutory formula imposed no tax on constitutionally exempt interest and that the exception provisions merely provided the reassurance of a judicial check of the correctness of this conclusion (105 Cong. Rec. 10412):

> As agreed to by the conferees, the final version of H.R. 4245 extensively rewrites the provisions of the House bill dealing with tax-exempt interest and dividends received, including the addition of a proviso to the effect that if in any particular case the formula under the bill does not provide the proper treatment of these items, appropriate adjustment will be made. It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendment, make no change of substance.

In the light of the foregoing history, it cannot seriously be contended that Congress did not "understand" the taxing formula or was unaware that its effect would be to require a company with tax-exempt interest to pay a higher tax than it would have had to pay had it not received that interest. Since it is self-evident that a reduced deduction means a higher tax, the effect of the House bill—which in terms reduced the reserve "deduction" if the company had tax-exempt interest—could not have been mistaken by anyone. Moreover, that obvious fact of arithmetic (and the corollary that, the tax advantages of tax-exempt bonds being reduced, the incentive of life insurance companies to buy them would be reduced) was repeatedly called to the attention of the Senate Finance Committee during its hearings on the bill (see pp. 64–65, *supra*). The identical effect of the Senate's revision of the bill—which treated a part of the tax-exempt interest as having been "absorbed" by the reserve exclusion and therefore reduced the company's further deduction for tax-exempt interest—was, if anything, even more obvious, and in any event it was expressly acknowledged by all that the Senate's bill produced results mathematically identical to those of the House bill (see Chairman Mills' comment on the bill as agreed to in conference, p. 70, *supra*).

The history in fact shows that Congress was more than merely *aware* that a company with tax-exempt interest would, under the Act, have to pay a higher tax than if it had not received the interest. It shows that that was precisely the result that Congress *wanted* and the only reason why it adopted the formula in

the first place. The only system of taxing life insurance companies under which the tax paid by a company with tax-exempt interest is no higher than if the company had not received the interest is one in which (1) a deduction or exclusion is allowed for the full amount of the tax-exempt interest and (2) a further deduction or exclusion is allowed for the full amount of the addition to the reserve, wholly ignoring the fact that a part of the income produced by the investment of the reserve funds (or from which the addition to the reserve is made) is itself tax-exempt. That, however, was the very system which the Ways and Means Committee described as permitting a "double allowance" (p. 63, *supra*) and which Congress has persistently sought, both in the 1942 Act and the 1959 Act, to replace with a more equitable formula which takes account of the fact that the tax-exempt income should bear (or contribute) its fair share of the addition to the reserve. The proration formula was adopted, therefore, precisely in order to impose a higher (*i.e.*, more equitable) tax on life insurance companies than they would have to pay if they were treated as not having received their tax-exempt interest at all (*i.e.*, if they were given a "double allowance"). To say that Congress did not "know" that result would be produced by the formula adopted, or did not "want" that result to be produced, is to deny the very reason for the development of the formula and to say that Congress has been unconscious of what the whole fight has been about over the many years that it has struggled to find an equitable basis for the taxation of life insurance companies.

While there was no issue in the hearings and debates about what the bill did—the mathematical results were plain and understood by everyone—there was a very substantial question about whether it was desirable as a matter of social and economic policy. On the one hand, it was argued by witnesses opposing the enactment of the bill that it was undesirable to tax insurance companies in a way that would (by reducing the advantages to them of tax-exempt interest) reduce their incentive to buy State bonds and thereby, perhaps, force State and local governments to pay a higher interest rate in order to sell their bonds (see, *e.g., Senate Hearings,* pp. 121–122). It was argued in favor of the bill, on the other hand, that, without the allocation provisions, life insurance companies could virtually eliminate any income tax by putting only a fraction of their investments into State bonds and corporate stocks (*id.* at 45–47). The nature of the argument is illustrated by the prolonged exchange between Senator Kerr and Mr. Beers, the president of Aetna Life Insurance Company, about the desirability of the treatment accorded corporate dividends (*id.* at 248, 260–266). Since corporations are generally allowed to exclude 85% of any dividends received from other corporations from their income (§ 243), such dividends represent, in effect, partially tax-exempt income. The bill (like the Act) accordingly treated the exempt portion of dividends in the same manner as it did interest from State bonds. Mr. Beers argued that, as a result of the bill's allocation of a pro rata part of the dividends to the reserve, a typical insurance company's taxable income would

increase by 60% of any additional corporate dividends received rather than by 15%, as in the case of ordinary corporations. Senator Kerr did not dispute Mr. Beers' arithmetic, but vigorously challenged his characterization of the result. A more accurate description of what happens, he argued, was that, while other corporations pay a tax on 15% of the total dividends they receive, a typical life insurance company receiving a total of $140,000 in dividends would pay a tax on only $6,000, or only on about 4% of the total dividends received. In short, there was no lack of understanding over what the bill did; the only question was whether what it did was desirable.

Congress, having considered all the arguments pro and con over the desirability of the effects the bill admittedly would have, decided on balance that the bill provided an equitable basis for the taxation of life insurance companies and that any adverse effects the bill might have on the market for State bonds were not great enough to warrant giving to insurance companies the unfair advantage of duplicating deductions or exclusions. Life insurance companies holding more than 70% of the industry's assets agreed that the bill provided an equitable method of taxation and should be adopted, saying (105 Cong. Rec. 8402): "The proration method of treating tax-free interest and the dividends received on corporate stock recommended by your committee is similar in principle to the one included in all laws since 1942 and we urge that it be adopted." The definitions of "gain from operations" and "taxable investment income" were enacted into law, in short, not because Congress

did not understand what they said or how they would operate, but because of a specific policy judgment, concurred in by the larger part of the insurance industry, that life insurance companies *should* be taxed in the way prescribed by those definitions.

Having formulated the definitions specifically in order to produce the results they do produce, and having decided as a matter of policy that that was the manner in which life insurance companies ought to be taxed, Congress was faced with one final issue: was the bill, desirable as it was, consistent with the general "constitutional" immunity of State bonds from federal tax? The Ways and Means Committee thought it plain that the bill did not impose a tax "on" tax-exempt interest (p. 63, *supra*). In the Senate Hearings, however, the constitutionality of the bill was vigorously disputed, with Senator Butler and several industry witnesses arguing that the bill was unconstitutional under *National Life* and *Gehner* and representatives of the Treasury arguing that it was constitutional (see p. 65, *supra*). The majority of the Senate committee not only agreed with the House and the Treasury but reformulated the definitions (to provide for a division of all the items of income pro rata between an excluded "policyholders' share" and the "company's share") in order to make it unmistakably clear that the tax-exempt interest was only being fairly allocated and was not itself being taxed (see Senator Curtis' statement, p. 68, *supra*).

At the same time that it revised the definitions to make it more clear that they did not impose a tax on tax-exempt interest, the Senate committee also added

the "exception" clause authorizing an adjustment to the tax if the Act should otherwise be held to result in "the imposition of tax on" interest from State bonds. Inasmuch as the committees of both Houses had satisfied themselves that the bill as written did not tax tax-exempt interest, the "exception" clause might well have been omitted. To be sure, the courts might disagree with the committees' judgment, but in that event the courts presumably would not need statutory authority to adjust the tax; the Court in *National Life* had drawn its warrant from the Constitution, not from Congress. But the fear expressed by Senator Butler was a reason for adding an express statutory caveat—namely, that the Treasury might make litigation under the Act the occasion for arguing not merely that the Act does not in fact tax interest from State bonds, but also that the whole doctrine of immunity should be overruled and the Court should hold that there is no constitutional barrier to taxing such interest (pp. 66–67, *supra*). The "exception" clause avoided that danger by providing a statutory adjustment should the Act be held to tax tax-exempt interest, thereby forestalling any challenge to the immunity of State bonds as a constitutional doctrine. That provides a fully satisfactory explanation of the "exception" clause and there is nothing to suggest that Congress intended anything more.

Since the Act does not impose a tax upon tax-exempt interest under the established constitutional doctrine, the exemption clause remains inoperative and the statutory formula must be given effect.

CONCLUSION

For the reasons stated, the judgment below should be reversed.

Respectfully submitted.

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APPENDIX A

COMPUTATION OF GAIN FROM OPERATIONS

1. Assume that a life insurance company has a total investment yield of $1,000,000, including $100,000 in interest from State bonds, and that the amount it is required under State law to add to its reserves for policyholder claims (the "reserve addition") is $800,000. The following schedule shows how the company's "gain from operations" is computed under the statutory formula (Case 1) and how the court of appeals' decision requires it to be computed (*i.e.*, by treating the company as though it had not received the interest from State bonds) (Case 2).

Schedule A

	Case 1 (tax-exempt interest included)	Case 2 (tax-exempt interest excluded)
1. Taxable income	$900,000	$900,000
2. Tax-exempt interest	100,000	0
3. Total investment yield (line 1+line 2)	1,000,000	900,000
4. Reserve addition	800,000	800,000
5. Company's share of investment yield (line 3—line 4)	200,000	100,000
6. Company's percentage share (line 5÷line 3)	20%	11.1%
7. Company's share of tax-exempt interest (line 6×line 2)	20,000	0
8. Net amount included in gain from operations (line 5—line 7)	$180,000	$100,000

2. Assuming the same facts, the following schedule shows how gain from operations would be computed if the interest from State bonds were first excluded in full and a "deduction" were then allowed for the reserve addition in proportion to the extent that the investment income consisted of taxable items:

Schedule B

1. Total investment yield	$1,000,000	
2. Tax-exempt interest	$100,000	
3. Taxable income (line 1—line 2)		$900,000
4. Ratio of taxable income to total investment yield (line 3÷line 1)—(per cent)	90	
5. Reserve addition	$800,000	
6. Deductible portion of reserve addition (line 4×line 5)		$720,000
7. Net amount includible in gain from operations (line 3—line 6)		$180,000

3. The computation of gain from operations is also depicted graphically on the fold-out chart inside the back cover of this brief. The entire square represents the total investment yield of $1,000,000. Vertically, the yield is divided according to its source, with the tax-exempt interest ($100,000) being represented by the diagonally-lined area and the taxable income ($900,000) being represented by the remaining (unlined) area. Horizontally, the yield is divided according to its distribution, with the "policyholders' share" ($800,000, equal to the addition to the reserve) being represented by the gray (*i.e.*, shaded) area and the "company's share" ($200,000, the amount remaining) being represented by the white (*i.e.*, unshaded) area. The result of the two divisions is to show the "policyholders' share" and the "company's share" of the yield as each consisting of a pro rata share of each kind of income: the unlined gray area represents the policyholders' share of the taxable income ($720,000) while the diagonally-lined gray area represents their share of the tax-exempt interest ($80,000); the unlined white area represents the company's share of the taxable income ($180,000) while the diagonally-lined white area represents its share of the tax-exempt interest ($20,000). The computation prescribed by the Act is thus graphically illustrated by the chart: from the total

yield ($1,000,000), there is subtracted first the entire gray area ($800,000) and then the diagonally-lined white area ($20,000), leaving only the unlined white area ($180,000) as the amount on which the company is taxed.

The chart can also be used to illustrate the alternative method of computation set out in Schedule B, *supra*. The gray area represents the total reserve addition ($800,000). If the reserve addition is treated as a "cost" of producing the investment income and is allocated in proportion to the kinds of income it produces, the unlined gray area ($720,000) represents the portion of the cost attributable to the production of the taxable income and the diagonally-lined gray area ($80,000) represents the portion attributable to the production of the tax-exempt interest. The alternative method of computation (in which there is subtracted first the full amount of the tax-exempt interest and then the portion of the reserve-addition "cost" allocable to the taxable income) may therefore be illustrated on the chart as follows: from the total yield ($1,000,000), there is subtracted first the entire diagonally-lined area ($100,000) and then the unlined gray area ($720,000), again leaving only the unlined white area ($180,000) as the amount on which the company is taxed.

The chart thus makes apparent the equivalence of the two methods of computation. Although the order of subtraction is somewhat different, they subtract the same areas and are but alternative methods designed to accomplish the same thing: to avoid subtracting the diagonally-lined gray area ($80,000) twice, once as part of the diagonally-lined area (tax-exempt interest) and once as part of the gray area (addition to the reserve).

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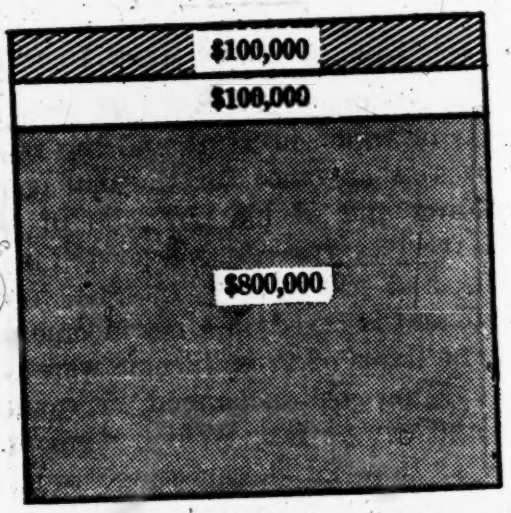
The chart also permits a ready visualization of the effect of changes in the investment yield. A change in the total amount of the investment yield would move the top line up or down; a change in the composition of the yield would move the verticle line separating the diagonally-lined area and the unlined area to the right or to the left. A *substitution* of tax-exempt interest for taxable income would thus simply move the vertical line to the left. An *incremental* receipt of tax-exempt interest, however, would both move the top line up (increasing the total yield) and move the vertical line to the left (changing the relative composition). The gray area ($800,000) is not affected by movements of the top line of the chart, reflecting the fact that the required addition to the reserve is a constant, unaffected by changes in the total investment yield. The extent to which the gray area is diagonally-lined or unlined is, however, affected by movements of the vertical line, reflecting the fact that the "policyholders' share" of the income is made up of a pro rata share of each kind of income (or that the reserve addition, seen as a cost, is chargeable proportionately to all the kinds of income produced by the investment of the reserve funds).

The method of computation urged by respondent and adopted by the court below can be visualized on

the chart by turning the vertical divisions to the horizontal, with the diagonally-lined area being superimposed on the top half of the white area, so that the chart would look like this:



The computation would then be as follows: from the total investment yield ($1,000,000), there is subtracted first the entire diagonally-lined area at the top of the chart ($100,000) and then the entire gray area at the bottom of the chart ($800,000), leaving only the unlined half of the white area ($100,000) as the amount on which the company is taxed.

APPENDIX B

EXAMPLES OF APPORTIONMENT PROBLEMS

Example 1. Assume that a taxpayer owns a building three-fourths of which he rents and the remainder of which he uses as an office for the management both of the building and of his portfolio of stocks and bonds. He receives gross income of $50 in rents, $30 in dividends, and $20 in bond interest, has expenses totalling $80, and is taxed on a net income of $20. If any one of the items of gross income were eliminated, leaving everything else unchanged, he would have no net income and pay no tax. Which items of gross income is the tax "on"? The question can be answered only by first making a reasonable allocation of the expenses among the several items of gross income. The following table illustrates how that might be done:

Table I

Income and Expenses	Unapportioned	Apportioned		
		Rents	Dividends	Interest
Gross Income	100	50	30	20
Expenses:				
Building expenses (apportioned by rental value of space and then by income from investments)	40	30	6	4
Office expenses (by time spent)	20	12	5	3
Interest paid on borrowings for investment (by value of investments)	10	--------	5	5
Safety deposit box (by bulk of documents)	5	--------	2	3
Investment counsel (by use)	5	--------	5	--------
Total expenses	80	42	23	15
Net income	20	8	7	5

Assuming the reasonableness of the allocations, it is apparent that the bond interest contributes only $5 to the net income. If the bonds were State bonds the interest on which was constitutionally immune from tax, it would be necessary, in order not to tax that interest, to reduce the net income only by $5, not by the full amount of the interest ($20).

Example 2. The following computation compares the depreciation allowable for an automobile if it is used solely for business purposes (Case 1) with that allowable if it is also used for personal purposes (Case 2). The fact that in Case 2 the allowable deduction is decreased, and the taxable income therefore increased, solely because of the use of the automobile for personal purposes does not mean that a tax is being imposed "on" the personal use itself.

Table II

	Case 1	Case 2
1. Cost of automobile	$2,000	$2,000
2. Depreciation rate	25%	25%
3. Depreciation (line 2×line 1)	$500	$500
4. Business use (in miles)	12,000	12,000
5. Personal use (in miles)	0	8,000
6. Percentage use in business (line 4÷(line 4+line 5))	100%	60%
7. Deductible depreciation (line 6×line 3)	$500	$300

Example 3. Assume that a trust instrument requires the trustee to pay *A* $80 a year out of the trust's income (or, if necessary, corpus) and to pay the balance of the income, if any, to *B*. In the first year of the trust, the trust receives only $80 of income, consisting of $40 in capital gains and $40 in dividends. As the following table illustrates, all of the income would be distributed to *A* and *A*'s receipts would be deemed to consist of all of each item of income:

Table III

Kinds of Income	Receipts	Distributions	
		To *A*	To *B*
Total income	$80	$80 (100%)	0
Items:			
Capital gains	40	40	0
Dividends	40	40	0
Taxable income	80	80	0

In the second year of the trust, the trust receives an additional $20 of income in the form of interest from State bonds, making the total income $100. Under the trust instrument, $80 would be distributed to *A* and the balance, $20, would be distributed to *B*. For tax purposes the distributions to each would be deemed to consist of a pro rata share of each item of income (§ 662), as shown by the following table:

Table IV

Kinds of income	Receipts	Distributions	
		To *A*	To *B*
Total income	$100	$80 (80%)	$20 (20%)
Items:			
Capital gains	40	32	8
Dividends	40	32	8
Bond interest (exempt)	(20)	(16)	(4)
Taxable income	80	64	16

A comparison of the two tables shows that the trust's receipt of an additional $20 of *tax-exempt* interest causes *B* to have *taxable* income of $16, notwithstanding that he would have had no taxable income and owed no tax if the trust had not received the interest (as was the case in the first year). And if *A* were a tax-exempt charity, the result would be that no tax at all would be due in the first year but a tax would be due on $16 of income in the second year, solely because of the trust's receipt of tax-exempt interest.

APPENDIX C

Internal Revenue Code of 1954, as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 26 U.S.C. 1958 ed., Supp. V.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) *General Rule.*—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

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SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

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(b) *Life insurance reserves defined.*

(1) *In general.*

For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*

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in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

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SEC. 802. TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In general.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

* * * * *

(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

* * * * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) *In general.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equal 100 percent.

* * * * *

(6) *Exception.*—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. * * *

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SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

* * * * * *

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. * * *

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(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rates.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

* * * * *

SEC. 809. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders.*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any items set aside for policyholders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

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(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

* * * * *

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

* * * * *

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

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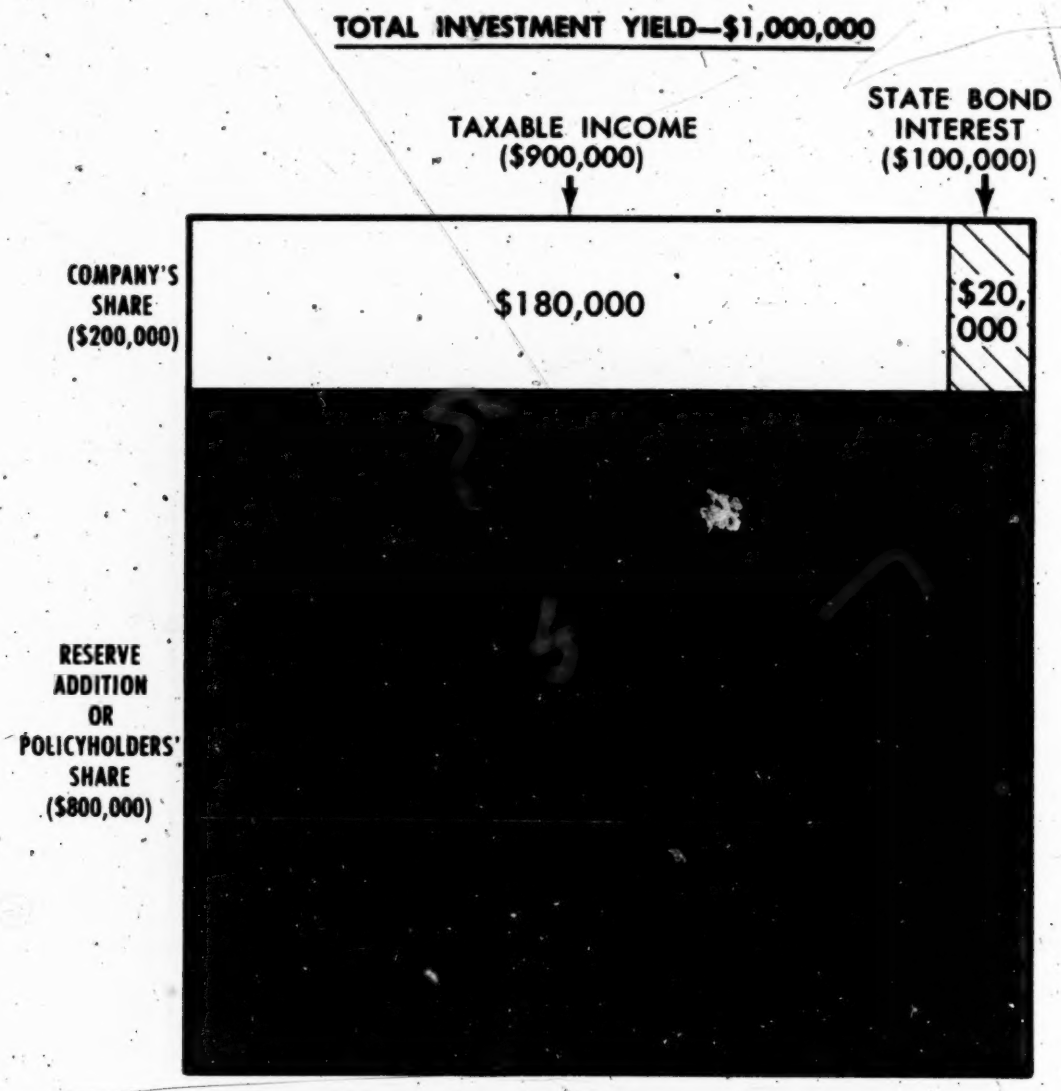
CHART SHOWING APPORTIONMENT OF INVESTMENT YIELD IN COMPUTATION OF GAIN FROM OPERATIONS

[Company with total investment yield of $1,000,000; interest from State bonds of $100,000; and a required addition to the policyholder reserves of $800,000.]



[For detailed explanation, see pp. 80–83, *supra*.]